TIMING AND MEASUREMENT OF TAXPAYER DEDUCTIONS FOR OBLIGATIONS TO BE PAID IN THE FUTURE

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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CONTENTS

Page

Press release of Wednesday, February 8, 1984, announcing the hearing 1

WITNESSES

Department of the Treasury, Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy 3
Congressional Research Service, Library of Congress, Donald W. Kiefer 110

Aidinoff, M. Bernard, Sullivan & Cromwell 40
Ambrose, Tommy W., Battelle Memorial Institute 89
American Council of Life Insurance, Gerard M. Brannon 104
American Institute of Architects, John I. Schlossman 207
American Institute of Certified Public Accountants, Albert B. Ellentuck 102
American Mining Congress, Dennis P. Bedell 36
American Public Power Association, David Sweetland and Frances Francis 190
Arthur Andersen & Co., Richard A. Helfand 96
Association of the Bar of the City of New York, Committee on Taxation, Victor F. Keen 47
Bailey, Don, National Coal Association 24
Battelle Memorial Institute, Tommy W. Ambrose 89
Bedell, Dennis P., American Mining Congress 36
Blomquist, Carl A., Mutual Protection Trust, and Cooperative of American Physicians, Inc 256
Brannon, Gerard M., American Council of Life Insurance 104
Commonwealth Edison Co. of Chicago, Al Noftz 173
Consolidated Freightways, Inc., Howard A. Young and James E. Merritt 230
Cooperative of American Physicians, Inc., Carl A. Blomquist 256
Cresse, Joseph P., Florida Public Service Commission, and National Association of Regulatory Utility Commissioners 84
Dawes, Paul H., Kaiser Steel Corp 224
Deloitte, Haskins & Sells, Emil M. Sunley 70
Drummond Coal Co., Joseph E. Nicholls, Jr 28
Edison Electric Institute, Al Noftz 173
Ellentuck, Albert B., American Institute of Certified Public Accountants 102
Federal Mogul Corp., Ronald W. Stasch 214
Florida Public Service Commission, Joseph P. Cresse 84
Francis, Frances, American Public Power Association 190
Ginsburg, Feldman & Bress, James K. Jeanblanc 46
Grafton Coal Co., Dwight Keating 33
Hamm, Steven W., National Association of State Utility Consumer Advocates 86
Helfand, Richard A., Arthur Andersen & Co 96
Hindman, Sally, Public Citizen's Critical Mass Energy Project 196
Hospital Corp. of America, Robert A. Reeves 244
Jeanblanc, James K., Ginsburg, Feldman & Bress 46
Kaiser Steel Corp., Paul H. Dawes 224
Keating, Dwight, Grafton Coal Co., and Mining and Reclamation Council of America 33
Keen, Victor F., Association of the Bar of the City of New York, Committee on Taxation 44
Lewis, James B., Paul, Weiss, Wharton & Garrison 46
McIntyre, James, Risk & Insurance Management Society, Inc 214
Merritt, James E., Consolidated Freightways, Inc 230
Mining and Reclamation Council of America, Dwight Keating 33

Page

Mutual Protection Trust, Carl A. Blomquist 256
National Association of Regulatory Utility Commissioners, Joseph P. Cresse 84
National Association of State Utility Consumer Advocates, Steven W. Hamm .. 86
National Coal Association:
Don Bailey 24
Joseph E. Nicholls, Jr 28
Nicholls, Joseph E., Jr., National Coal Association and Drummond Coal Co 28
Noftz, Al, Edison Electric Institute, and Commonwealth Edison Co. of Chicago 173
North Attleboro (Mass.) Electric Department, David Sweetland 190
Paul, Weiss, Wharton & Garrison, James B. Lewis 46
Public Citizen's Critical Mass Energy Project, Sally Hindman 196
Reeves, Robert A., Hospital Corp. of America 244
Risk & Insurance Management Society, Inc., James McIntyre and Ronald W. Stasch 214
Schlossman, John I., American Institute of Architects 207
Stasch, Ronald W., Federal Mogul Corp. and Risk & Insurance Management Society, Inc 214
Sullivan & Cromwell, M. Bernard Aidinoff 40
Sunley, Emil M., Deloitte, Haskins & Sells 70
Sweetland, David, American Public Power Association, and North Attleboro (Mass.) Electric Department 190
Young, Howard A., Consolidated Freightways, Inc 230

SUBMISSIONS FOR THE RECORD

American Medical Association, James H. Sammons, M.D., letter 267
American Petroleum Institute, Charles J. DiBona, letter 267
Bear Creek Uranium Co., Byrle M. Abbin, Arthur Andersen & Co., letter and attachments 270
Georgia Power Co., Warren Y. Jobe, statement 283
Middle South Services, Inc., Malcolm H. McLetchie, letter 284
National Council of Self-Insurers, Douglas F. Stevenson, letter 285
Philadelphia Electric Co., Joseph F. Paquette, Jr., letter 285
Southern Co., Dean Hudson, letter and attachment 286
Thomas, Hon. William M., a Representative in Congress from the State of California, statement 256

TIMING AND MEASUREMENT OF TAXPAYER DEDUCTIONS FOR OBLIGATIONS TO BE PAID IN THE FUTURE

FRIDAY, FEBRUARY 24, 1984

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press release of Wednesday, Feb. 8, 1984]

HON. CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, ANNOUNCES HEARING TO EXAMINE THE TIMING AND MEASUREMENT OF TAXPAYER DEDUCTIONS FOR OBLIGATIONS TO BE PAID IN THE FUTURE

The Honorable Charles B. Rangel (D., N.Y.) Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, announced today that the Subcommittee will hold a public hearing on issues regarding deductions to accrual basis taxpayers for amounts relating to a future obligation or liability. The hearing will be held on Friday, February 24, 1984, beginning at 10:00 a.m. in the Committee's Main Hearing Room, 1100 Longworth House Office Building.

The Subcommittee will examine (1) present law tax and accounting principles affecting the timing and amount of deductions for obligations to be paid in the future (including amounts set aside or paid into a reserve account), and (2) the extent which present law accounts for the time value of money.

Under present law, deductions by accrual basis taxpayers are allowable when all the events which establish the fact of liability have occured and the amount thereof can be determined with reasonable accuracy. Accordingly, present law generally does not permit a current deduction for amounts set aside in a fund or trust to satisfy contingent liabilities. Also, such a fund or trust (and income therefrom), generally does not qualify for tax-exempt status.

Testimony will be received from invited and public witnesses, representatives of the Department of the Treasury, tax and economic policy experts, accounting and legal professional associations, the insurance industry, physician groups, nuclear power plant and mining firms and other interested parties.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than noon, Friday, February 17, 1984, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Subcommittee are

required to submit 100 copies of their prepared statements to the Main Committee office, Room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

Each statement to be presented to the Subcommittee or any written statement submitted for the record must contain the following information:

(1) The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

(2) A list of any clients or persons, or any organization for whom the witness appears; and

(3) A topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, six copies are required and may be submitted by the close of business Friday, February 24, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing begins.

Chairman RANGEL. The Subcommittee on Oversight of the Committee on Ways and Means will come to order.

This morning the Subcommittee on Oversight will conduct a hearing on the timing and amount of deductions set aside in reserve accounts or to self-insure for liabilities or obligations to be satisfied in the future.

In 1954, a provision was enacted, IRC section 462, to allow accrual method taxpayers a deduction for a reasonable addition to a reserve for estimated business expenses. Section 462 was enacted in response to President Eisenhower's 1954 budget request that certain principles of tax accounting be brought more into line with accepted business accounting principles.

Specifically, section 462 allowed taxpayers to deduct from income amounts put into a reserve for certain estimated future business expenses. However, IRC section 462 was repealed a year later, in 1955, retroactively. Legislative reports indicate that IRC section 462 was repealed in order to "guard against the unintended and unexpected revenue loss."

Numerous bills have been introduced since 1955 which would allow business taxpayers to deduct amounts set aside in reserves for estimated future expenses. Included are current legislative proposals relating to nuclear decommissioning expenses and mining reclamation costs. There are also proposals relating to reserve accounts for business-related tort liabilities, certain physicians' malpractice liabilities, and, in earlier years, proposals relating to products liability funds. While these bills have not been specifically referred to the subcommittee, we will receive testimony regarding policy issues they raise.

Under present law, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. This standard is known as the "all events" test.

Although a body of case law has been developed with regard to accruals for expenses to be paid in the future and the all events test, there is still uncertainty regarding the application of the test to various types of industry expenses. In addition, the administration's budget contains proposals concerning "premature accruals" which would modify the all events test.

The subcommittee has invited the administration, tax and accounting experts, and representatives of a number of industry groups to present testimony on these issues.

Since we have a large number of witnesses scheduled to appear today, I must enforce the rule that witness statements be limited to no more than 5 minutes. However, I encourage witnesses to summarize their statements as much as possible so that members of the panel will have the opportunity to ask questions.

The complete statement of each witness in every case will be included in the printed record.

Mr. Duncan.

Mr. DUNCAN. I have no statement to make, Mr. Chairman, other than to thank you for holding these hearings.

Chairman RANGEL. Mr. Dorgan.

Mr. DORGAN. I have no statement, Mr. Chairman.

Chairman RANGEL. Mr. Thomas.

Mr. THOMAS. No statement, Mr. Chairman.

Chairman RANGEL. Let's begin with Mr. Pearlman, the Deputy Assistant Secretary for Tax Policy of the U.S. Department of the Treasury.

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Thank you, Mr. Chairman.

I appreciate the opportunity to describe the administration's proposals as they relate to the timing and measurement of deductions for obligations to be made in the future.

As you know, Buck Chapoton appeared Wednesday before the full committee to present the administration's proposals in the area of tax shelters, accounting abuses, certain corporate and securities transactions. One of the administration's proposals in the area of accounting abuses will correct defects in current law that allow accural method taxpayers to overstate deductions for certain future expenses.

It is my purpose this morning to describe in more detail our reasons for this proposal. Let me point out that the administration's proposal would establish one uniform method by which all accrual method taxpayers who account for future expenses. We believe the proposal is fair, simple and administrable. The bills that are the subject of this hearing pertain to treatment of future deductions, such as decommissioning of nuclear powerplants, business deductions related tort liabilities and physician malpractice insurance funds.

Our written statement submitted for the record does not address these bills in specific detail. We will, however, submit in the near future a statement presenting our views on these bills.

I would like first to describe the time value of money concept that underlies many of the administration's proposals to correct accounting abuses. I will then briefly explain the administration's concern with certain judicial interpretations of existing law and finally describe the administration's proposals and explain the reasons we believe our proposal represents the only administrable method of accounting for future expenses in a system that properly reflects the time value of money.

High interest rates and high inflation rates such as we have had in the past two decades, resulted in material increases in the time value of money. That concept measures the difference between the value of immediately available funds and the right to receive funds or the obligation to expend funds at some time in the future. In the simplest terms, we mean that the right to receive $10 today is obviously more valuable than the right to receive $10 at some future year. Or similarly, the obligation to incur expenses of $10 in the future is less onerous than the obligation to pay expenses of $10 today.

The reason why the amount of funds available today is more valuable than the same nominal amount to be available in the future is that the funds available today can be invested to yield a return which can be added to the principal. Thus the difference in value today between $10 and a $10 receivable or payable in the future is normally measured by reference to the interest that could be earned by investing the principal.

For example, if we had $10 which we could set aside to earn income today, assuming a 10 percent interest rate, that $10 would be worth $11 a year from now. The $11 a year from now, therefore, is equivalent to $10 today or put another way, $11 a year from now, has a present discounted value of $10 today assuming a 10 percent discount rate.

Tax policy considerations require that a deduction for a future expense reflect time value of money concepts. A liability to incur a future deductible expense in the amount of $10 has a present discounted value of less than $10. From a tax policy standpoint, a taxpayer's deduction should be $10 if deductible when the liability is satisfied. If the deduction is allowed prior to the time the liability is satisfied, the deduction should be equal to the principal amount which would grow at the approximate after tax rate to $10 in the year the liability is satisfied.

An example that will illustrate the magnitude of the revenue loss that may be associated with an overstatement might be helpful. Assume that we have an accrual basis taxpayer who becomes obligated in 1984 to render a service in 1991 and that the taxpayer can estimate with reasonable accuracy in 1984 that the cost of rendering the service in 1991 is $1 million. If we assume an 8 percent after tax discount rate between 1984 and 1991, then 1991 the expense will have a present value of approximately $583,000. If we permitted the taxpayer to deduct the entire $1 million in 1984 that deduction overstates the true economic cost of the taxpayer by approximately $400,000.

Using those numbers the tax law should either limit the current deduction to the present value of the $583,000 or require the full $1 million be deducted only when the liability is satisfied 7 years in

the future. To allow the taxpayer an undiscounted current deduction of $1 million means that the Government pays a major portion of the future expense.

Assuming that the taxpayer is in a 50 percent bracket, the Government would end up paying in 1984 more than 85 percent of the true economic cost of the liability in my example.

Indeed if the liability is not satisfied until some time after 1993 the Government in effect would grant the taxpayer benefits through the tax system that would exceed the true cost of the liability.

This example demonstrates the economic equivalence of allowing a present discounted value deduction or allowing the deduction for the full value when the liability is satisfied. The translation of that example into a workable tax provision presents a number of problems. It is important to keep in mind that while every businessman and every investor in dealing in day-to-day things understands there is a time value of money concepts. The appropriate measure of that may involve estimates and uncertainties that become very difficult to make specific. The design of tax rules to take account of the time value of money in the real business world and in real investment transactions must be sensitive to the practical difficulties of measuring the time value of money.

Under current law, under the accrual method of accounting an expense is deductible for the taxable year in which all the events have occurred that determine the fact of the liability, and the amount thereof can be determined with reasonable accuracy.

This is referred to as the all-events test of the Treasury regulations. The Internal Revenue Service's view is and has been that under the all-events test a liability cannot be fixed and a deduction is therefore not allowed unless there is a current liability to pay the deductible expense.

Recent court decisions concerning various types of liability for future expenses have created uncertainty as to the general applicability of the test. For example, the tax court in 1981 in the *Ohio River Collieries* case held that future cost attributable to an obligation imposed by State law to reclaim land damaged by mining could be deducted at the time the land was mined provided that the amounts of such future expenses could be estimated with reasonable accuracy.

This case ignored time value of money concepts. Taxpayers outside the mining area have relied on this case in claiming current deductions for the undiscounted amount of expenses to be paid in the future. Previously we have testified that in our view the *Ohio River Collieries* case was incorrectly decided.

Similarly in the area of workers compensation the courts have held under the all-events test that an employers' liability becomes fixed with respect to an uncontested claim when the injury occurs. The IRS announced it will not follow these cases. Nevertheless, last year the court of appeals for the 9th Circuit in the *Kaiser Steel Corp.* case held that an employer could deduct currently the estimated amounts payable in future years with respect to injuries suffered by its employers during the taxable year.

It is important to note that the court accorded no significance to the fact that some payments were made more than 17 years after

the injuries were sustained. We believe the *Kaiser* case was decided incorrectly. Moreover, the decision created additional uncertainty as to whether taxpayers in a variety of contexts may establish deductible reserves for future expenses.

In spite of these adverse decisions let me point out that we believe that if this issue were presented to the Supreme Court, it would agree with our time value of money proposals. Indeed in the *Dickman* case decided this week by the Supreme Court involving the gift tax on an interest free loan, the court in effect did recognize the time value of money. Indeed even the dissent in the *Dickman* case recognized the conceptual accuracy of time value concepts but indicated that that result should be dealt with by legislation.

The failure of these recent court decisions to which I have referred to recognize the difference between the true economic cost of expenses paid today or paid in the future may permit taxpayers to obtain substantial unwarranted tax benefits in ordinary business activities and in abusive tax shelter transactions. The uncertainty that these cases has created which now surrounds the deduction for future expenses extends to numerous business activities that give rise to obligations to pay expenses in the future.

For example, employment-related accidents may involve workers compensation claims, other accidents may give rise to tort liabilities, I have mentioned strip mining which will often require future reclamation costs; the operation of a nuclear powerplant will necessitate eventual decommissioning of the plant; offshore oil drilling will necessitate the eventual removal of the drilling platform.

A tax shelter partnership may be obligated to pay research expenditures in the future. Similarly some employers incur liabilities to make contributions to voluntary employee beneficiary associations. Others incur liabilities to make future payments to employees and their dependents upon termination, for example upon the closing of a plant.

To the extent that current law is interpreted to permit taxpayers to deduct these expenses currently, the all-events test will result in a substantial revenue loss to the Government. Even for business expenses that will be incurred in a relatively short term, 3 or 4 years, for example, the allowance of a current deduction of an undiscounted expense materially overstates the taxpayers' income.

Turning now to the administration's proposal. Our proposal is designed to curb overstated deductions for future expenses to which I have referred by amending the all-events test to provide that no deduction will be allowed to accrual method taxpayers prior to the time of economic performance in respect to a particular liability.

This rule will be illustrated by reference to several common situations where payment of an expense occurs significantly later than the event that gives rise to the ultimate liability.

For example, economic performance will be defined to occur in the case of an obligation to pay research and experimentation expenses when the research is performed. Or in the case of workers compensation claims or structured settlements in tort liabilities when payment is made which will extinguish the liability to the claimant.

In the case of a strip mine where land needs to be reclaimed, economic performance occurs when the land is reclaimed. In the case of the nuclear powerplant or offshore drilling rig it is when the facility is decommissioned or dismantled. We recognize that requiring deductions for future expenses to be taken in the year of economic performance also requires that the net operating carryback rules be amended to insure that taxpayers are not overtaxed. Our proposals provide for extension of the carryback period in appropriate circumstances to insure that the deferred expenses will be able to be fully utilized.

Generally expenses attributable to liabilities arising more than 3 years prior to economic performance will be permitted to be carried back for a period not to exceed 10 years, subject to certain transition rules. Special carryback rules might be appropriate for certain expenses to be paid in the future such as the nuclear powerplant decommissioning costs.

The premature accrual rule would not apply to transactions that have specific statutory rules governing the timing of deductions.

We recognize that generally accepted accounting principles frequently require establishment for financial accounting purposes of current reserves for future expenses, thus reducing net profit as reported on financial statements.

However, reserve accounting is not an appropriate means for reflecting future expenses for Federal income tax purposes. If taxpayers were allowed to establish deductible reserves in the first years after enactment there would be a substantial revenue loss as reserves were established for future expenses and deductions were permitted for such expenses as to which no deductions had previously been allowed. As you mentioned in your opening statement, Congress found such a loss inherent in section 462 to be unacceptable and thus repealed section 462 less than 12 months after its enactment.

Moreover, there are no apparent workable limitations on the categories or amounts of future expenses for which reserves could be established and current deductions claimed.

Let me note that in House bill 2820 which is one of the bills that is being considered, utilities would be allowed in connection with operating nuclear powerplants to establish currently deductible reserves to cover future decommissioning costs to the extent amounts are required to be set aside. However, House bill 2820 contains no provisions for insuring that the reserves will be limited to the present value of future expenses. In fact, the bona fide concerns of utility regulators would be to require overfunding of reserves.

Decommissioning a nuclear facility involves the application of untried technology. The uncertain costs associated with that process is a burden that regulators would want to be borne by the customers of the utilities, not by public authorities.

Absent certainty as to timing of cost and the level of the cost, the regulators will tend to err on the side of caution. While this may represent prudent regulatory practice it should not be used as a justification for excessive tax deductions that will result in the Federal Government and indirectly all taxpayers subsidizing the decommissioning costs.

Moreover, the bill does not attempt to prescribe a method for recapturing reserves that prove to be excessive. These deficits in the bill underscore the difficulty inherent in allowing taxpayers to establish reserves for future expenses in amounts determined by them or by rate regulators.

As an administrative matter determining the present discounted values for all kinds of future expenses would introduce unmanageable uncertainty and undesirable complexity. Discount rates could not be determined individually for business, rather certain economy wide average discount rates would have to be employed. These discount rates would have to be applied to mere estimates of the amount of the expenses to be incurred and estimated dates in the future.

The discounted present value of these future expenses therefore would be wrong in every case in which the amount of the future expense, the time for economic performance or the discount rates was estimated incorrectly.

To provide some incentive for taxpayers to make reasonable estimates, a system that allowed deductions for discounted future expenses would have to include a complex set of computation rules for recalculating overstated and understated deductions when the future liabilities were in fact satisfied at a time or in an amount different from that originally projected. The complexities and difficulties in allowing a present value deduction for future expenses can be illustrated in the case of a strip mining operation which works a mining area over a long period of time and attempts to reclaim land as mining in a particular sector ceases.

The amount of land reclaimed each year will undoubtedly vary with the process of mining but generally a company may expect to reclaim sectors within 3 or 4 years after mining commences in a particular sector. If the mining operations begin in 1984 the company might predict that one sector of the land area will be reclaimed each year beginning a couple years in the future, for example 1987.

So the company might estimate in 1984 that the cost of reclamation of one sector in 1987 will be $1 million and that the costs of reclamation of additional sectors in subsequent years increases by an inflation rate of 5 percent. Under a system allowing present value deductions for future reclamation expenses, the company could use a prescribed discount rate to measure the present value of expenses for several years beyond 1987. If the reclamation does not begin until 1988 and takes place at varying rates, for example, more than one sector in a year or less than one sector in a year, the company would have either overstated or understated its 1984 deduction.

The company also would have incorrectly stated its prior year's deductions if the inflation rate differs from 5 percent or if technology changes the real cost of reclamation or finally if the company's actual rate of return varies from the prescribed rate of return. The recomputation of the true economic cost of reclamation would require a complex inventory system so as to permit comparing earlier deductions with discounted values of actual expenses incurred in 1988 and beyond. It would be very difficult to know whether expenses incurred in 1988, 1989, 1990, for example, represent expenses previously deducted in 1984, 1985.

Thus, any meaningful recomputation system for recapturing overstated expenses or for allowing additional deductions for understated expenses would be quite complicated and very difficult to administer.

In sum, the complexity of any system that permits deductions of discounted values of future expenses makes such a system unattractive. The alternative suggested in our proposal achieves comparable economic results without imposing the administrative burdens.

In conclusion, Mr. Chairman, we believe the administration's proposal that expenses be accrued only when economic performance occurs is the best means of providing a method for accounting for future expenses that is administrable, fair and prevents taxpayers from taking deductions for future expenses in excess of their true economic cost.

Thank you.

[The prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the committee, I am pleased to appear before you today to describe the Administration's proposals as they relate to the timing and measurement of deductions for obligations to be paid in the future.

Assistant Secretary Chapoton appeared earlier this week before the full Committee on Ways and Means to present the Administration's proposals in the area of tax shelters, accounting abuses, and certain corporate and securities transactions. One of the Administration's proposals in the area of accounting abuses would correct defects in current law that allow accrual method taxpayers to overstate deductions for certain future expenses. My testimony this morning will describe in more detail our reasons for this proposal.

Let me point out that the Administration's proposal would establish one uniform method by which all accrual method taxpayers would account for future expenses. We believe our proposal is fair, simple and readily administrable. The bills that are the subject of this hearing pertain to the treatment of future expenses in particular contexts such as decommissioning of nuclear power plants (H.R. 2820), mining reclamation (H.R. 3342), business-related tort liabilities (H.R. 2642) and physicians' malractice insurance funds (H.R. 4859). We are not able today to address in detail the specific provisions of these bills. We will, however, submit in the near future a detailed statement presenting our views on these bills.

I would like first to describe the time value of money concept that underpins many of the Administration's proposals to correct accounting abuses. I would then like to explain the Administration's concern that recent judicial interpretations of existing law often ignore time value of money concepts with respect to deductions for future expenses taken by accrual method taxpayers. Finally, I would like to describe the Administration's proposal and explain the reasons why we believe that our proposl represents the only administrable method of accounting for future expenses in a tax system that properly reflects the time value of money.

THE TIME VALUE OF MONEY CONCEPT

The high interest and inflation rates that we have experienced in the last two decades highlight economic assumptions that underlie certain provisions of the the Internal Revenue Code. These high rates have resulted in a material increase in the "time value of money."

The time value of money is the difference between the value of immediately available funds and the right to receive funds (or the obligation to expend funds) at some time in the future. In the simplest terms, the right to receive $10 today is more valuable than the right to receive $10 in some future year. Similarly, the obligation to incur expenses of $10 in the future is less burdensome than the obligation to pay expenses of $10 today. The reason why an amount of funds available today is more valuable than the same nominal amount to be made available in the future is that funds available today (i.e. principal) can be invested to yield to return which can be added to the principal. The difference in value between $10 today and $10 receivable

or payable in the future is usually measured by reference to the interest that could be earned by investing the principal.

These concepts can be illustrated with a simple example. Assuming that an individual could earn 10 percent on $10 made available today, his $10 would grow to $11 after one year. Thus, making available to the individual $11 after one year has the same value to him as making available $10 today. For this individual, $11 made available one year from today has a discounted value today of $10, assuming a discount rate of 10 percent.

Tax policy considerations require that a deduction for a future expense reflect time value of money concepts. As shown above, a liability to incur a future deductible expense in an amount of $10 has a present discounted value of less than $10. From a tax policy point of view, a taxpayer's deduction should be $10 if deducted when the liability is satisfied. Alternatively, if a deduction is allowed prior to the time the liability is satisfied, the deduction should be equal to that principal amount which would grow at the appropriate after tax rate of return to $10 in the year the liability is satisfied.

Disregard of time value of money principles results in overstated deductions and significant revenue loss. An example illustrates the magnitude of this revenue loss. Assume that an accrual method taxpayer becomes obligated in 1984 to render a service in 1991, and that the taxpayer can estimate with accuracy in 1984 that the cost of rendering the service in 1991 will be $1,000,000. If we assume an 8 percent after-tax discount rate between 1984 and 1991, the taxpayer's 1991 expense has a present discounted value in 1984 of approximately $583,500. If the taxpayer is allowed to deduct $1,000,000 in 1984, such a deduction overstates the true economic cost of the future expense by $416,500.

In the above example, the tax law should either limit the taxpayer's current deduction to its present discounted value of $583,500, or require that the full $1,000,000 be deducted only when the liability is satisfied in 1991. To allow the taxpayer an undiscounted current deduction of $1,000,000 means that the government would be paying a major portion of the future expense. Assuming that the taxpayer is in a 50 percent rate bracket, the government would end up paying in 1984 for more than 85 percent of the true economic cost of the liability. (The $1,000,000 deduction has a tax benefit to a 50 percent shareholder of $500,000. The true economic cost of the liability is $583,500. Thus, the tax benefit represents 85 percent of the true economic cost.) Indeed, if the liability were not satisfied until some time after 1993, the government, in effect, would grant the taxpayer tax benefits that exceed the true cost of the liability.

The foregoing example demonstrates the economic equivalence of allowing a present discounted value deduction or allowing a deduction for the full value of an expense when the liability is satisfied. However, the translation of a simple example into a tax code provision that measures discounted values presents numerous problems. It is important to keep in mind that while every businessman and investor intuitively understands that there is a time value of money, the appropriate measure of this value may involve estimates and uncertainties that become imponderables. The design of tax rules to take account of time value in the real world of business and investment transactions must be sensitive to the practical difficulties of measuring the time value of money.

TAX TREATMENT OF DEDUCTIONS FOR FUTURE EXPENSES UNDER CURRENT LAW

Under the accrual method of accounting, an expense is deductible in the taxable year in which all the events have occurred that determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. This is the so-called "all events" test of the Treasury Regulations. The view of the Internal Revenue Service has been and remains today that, under the "all events" test, a liability cannot be fixed, and a deduction is not allowable, unless there is a current liability to pay the deductible expense.

Recent court decisions concerning various types of liabilities for future expenses have created much uncertainty as to the general applicability of the all-events test. For example, the Tax Court in *Ohio River Collieries* v. *Commissioner*, 77 T.C. 1369 (1981), held that future costs attributable to an obligation imposed by state law to reclaim land damaged by mining could be deducted at the time the land was mined, provided the amounts of such future expenses could be estimated with reasonable accuracy. This case ignored time value of money concepts. Taxpayers conducting non-mining activities have relied on this case in claiming current deductions for the undiscounted amount of expenses to be paid in the future We have testified previously that in our view *Ohio River Collieries* was decided incorrectly.

In the context of worker's compensation claims, the courts have held that under the "all-events" test, an employer's liability becomes fixed with respect to an uncontested claim when the injury occurs. The Internal Revenue Service has announced that it will not follow these cases. Last year, however, a court held that an employer could deduct currently the estimated amounts payable in future years with respect to injuries suffered by its employees during the taxable year. In that case, the court permitted the current deduction even through the taxpayer's estimate of the amounts it would pay in the future was based on the aggregate estimated payments expected to be made to all workers injured during the year, rather than on the basis of the estimated amounts payable in respect of individual claims. It is important to note that the court accorded no significance to the fact that some payments were to be made more than 17 years after the injuries were sustained. *Kaiser Steel Corp.* v. *United States*, 411 F.2d 335 (9th Cir. 1983). We believe the *Kaiser* case was decided incorrectly. Moreover, the decision has created additional uncertainty as to whether taxpayers in a variety of contexts may establish deductible reserves for future expenses.

The failure of these recent court decisions to recognize the difference in the true economic cost of expenses paid today or paid in the future may permit taxpayers to obtain substantial unwarranted tax benefits, in ordinary business activities and in abusive tax shelter transactions. The uncertainty that now surrounds deductions for future expenses extends to numerous business activities that give rise to obligations to pay expenses in the future. For instance, an employment-related accident may involve a worker's compensation claim; other accidents may give rise to tort liabilities; the strip mining of a tract of land will often necessitate future reclamation costs; the operation of a nuclear power plant will necessitate the eventual decommissioning of the plant; offshore oil drilling will necessitate the eventual removal of the offshore drilling platform; and a tax shelter partnership may be obligated to pay research and experimentation expenditures in the future. Similarly, some employers incur liabilities to make periodic contributions to voluntary employees' beneficiary associations; others incur liabilities to make future payments to employees and their dependents if the employees are terminated upon the closing of a plant. To the extent current law is interpreted to permit taxpayers to deduct currently these types of future expenses, the "all events" test will result in a substantial revenue loss to the Treasury. Even for business expenses that will be paid in the relatively near future, such as 3 or 4 years, the allowance of a current deduction of an undiscounted expense materially overstates a taxpayer's income.

ADMINISTRATION PROPOSAL

The Administration's proposal will curb overstated deductions for future expenses by amending the "all events" test to provide that no deductions will be allowed to accrual method taxpayers prior to the time economic performance in respect of particular liabilities occurs. This rule may be illustrated by reference to several common situations where payment for an expense occurs significantly later than the event that gives rise to the ultimate liability. For example, economic performance will be defined to occur in the case of an obligation to pay research and experimentation costs when the research is performed. Similarly, economic performance in respect of worker's compensation claims or structured settlements of tort liabilities will occur when payments are made extinguishing liabilities to claimants; in strip mining cases when the land is reclaimed; in nuclear power plant or offshore drilling cases when the facility is decommissioned or dismantled.

We recognize that requiring deductions for future expenses to be taken in the year of economic performance also requires the net operating loss carryback rules to be amended to ensure that a taxpayer will not be overtaxed. We propose to extend the carryback period in appropriate circumstances to ensure that deferred expenses may be utilized fully. Generally, expenses attributable to liabilities arising more than 3 years prior to economic performance will be permitted to be carried back for a period not to exceed 10 years, subject to transition rules. Special carryback rules might be appropriate for certain expenses to be paid far in the future such as nuclear power plant decommissioning costs.

The premature accrual rule would not apply to transactions that have specific statutory rules governing the timing of deductions, such as transfers to which section 83 applies; bad debt deductions provided under section 166; any transaction to which section 267 applies; employer contributions or compensation to which section 404 applies; or an accrual to which section 463 or 466 applies (relating to vacation pay and qualified discount coupons).

We recognize that generally accepted accounting principles frequently require the establishment, for financial accounting purposes, of current reserves for future expenses, thus reducing net profit as reported on financial statements. However, reserve accounting is not an appropriate means of reflecting future expenses for federal income tax purposes.

If taxpayers were allowed to establish deductible reserves, in the first years after enactment there would be a substantial revenue loss as reserves were established for future expenses and deductions were permitted for current expenses as to which reserves had not previously been allowed. Congress found such a revenue loss, which was inherent in the reserve concept of section 462, to be unacceptable. For this reason, this section was repealed less than 12 months after its enactment. Moreover, there were no apparent workable limitations on the categories or amounts of future expenses for which reserves could be established and current deductions claimed.

As an administrative matter, determining the present discounted values for all kinds of future expenses would result in unmanageable uncertainty and undesirable complexity. Discount rates could not be determined individually for each business. Rather, certain economy-wide average discount rates would have to be employed. These discount rates would have to be applied to mere estimates of the amount of the expenses to be incurred at estimated dates in the future. The discounted present value of these future expenses therefore would be wrong in every case in which either the amount of the future expenses, the time for economic performance or the discount rate was estimated incorrectly. To provide some incentive for taxpayers to make reasonable estimates, a system that allowed deductions for discounted future expenses would have to include a complex set of computation rules for recalculating overstated and understated deductions when the future liabilities were actually satisfied at a time or in an amount different from that originally projected.

The complexities and difficulties in allowing a present value deduction for future expenses may be illustrated in the case of a strip mining operation which works a mining area over a long period of time and attempts to reclaim land as mining in a particular sector ceases. The amount of land reclaimed each year may vary with the progress of the mine, but, generally, the company may expect to reclaim sectors within three or four years after mining commences in such sectors. If the mining operations begin in 1984, the company might predict that one sector of the land area will be reclaimed each year commencing in 1987. The company might estimate in 1984 that the cost of reclamation of one sector in 1987 will be $1 million and that the costs of reclamation of additional sectors in subsequent years increase by an inflation rate of 5 percent. Under a system allowing present value deductions for future reclamation expenses, the company could use a prescribed discount rate to measure the present value of reclamation expenses for several years beyond 1987. If reclamation does not begin until 1988, and takes place at varying rates, i.e. sometimes more than one sector, sometimes less than one sector is reclaimed each year, the company would have either overstated or understated its deduction in 1984. The company also would have incorrectly stated its prior years deductions if the inflation rate differs from 5 percent, if technology changes the real cost of reclamation, or if the company's actual rate of return varies from the prescribed rate of return.

The recomputation of the true economic cost of reclamation would require a complex inventory system in order to permit comparing earlier deductions with the discounted values of actual expenses incurred in years 1988 and beyond. It would be very difficult to know whether expenses in years 1988, 1989, and 1990 represent expenses previously deducted in 1984, 1985 or some other year. Thus, any meaningful recomputation system for recapturing overstated expenses or for allowing additional deductions for understated expenses would be quite complicated and difficult to administer.

In sum, the complexity of any system that permits deductions of discounted values of future expenses makes such a system unattractive. The alternative suggested in our proposal achieves comparable economic results without imposing the administrative burdens.

We note that H.R. 2820 would allow utilities operating nuclear power plants to establish currently deductible reserves to cover future decommissioning costs to the extent amounts are required to be set aside. However, H.R. 2820 contains no provisions for ensuring that reserves will be limited to the present value of future expenses. In fact, the bona fide concerns of the utility regulators would result in the overfunding of reserves. Decommissioning a nuclear facility involves the application of untried technology; the uncertain costs associated with that process are a burden that the regulators would want to be borne by the customers of the utilities—not by public authorities. Absent certainly as to the timing and level of costs, the regula-

tors will tend to err on the side of caution. While this may represent prudent regulatory practice, it should not be used as a justification for excessive tax deductions that would result in the government, and indirectly all taxpayers, subsidizing the decommissioning costs. Moreover, the bill does not attempt to prescribe a method for recapturing reserves that prove to be excessive. These deficiences underscore the difficulty inherent in allowing taxpayers to establish reserves for future expenses in amounts determined by them or by rate regulators.

CONCLUSION

In conclusion, we believe that the Administration's proposal that expenses be accrued only when economic performance occurs is the best means of providing a method of accounting for future expenses that is administrable, fair and prevents taxpayers from taking deductions for future expenses in excess of their true economic cost.

I would be pleased to answer any questions.

Chairman RANGEL. Thank you.

The administration's basic position is to allow the deduction only in the year of the economic performance. That to do it any other way would just be too complex and difficult to administer.

Mr. PEARLMAN. Yes, Mr. Chairman, we acknowledge that a present value deduction, if we can accurately determine it, conceptually reaches the right result. But to put that system into effect requires a level of complexity, which the strip mining case that I included in my comments illustrates, that make it extremely difficult to administer.

Chairman RANGEL. And the administration finds no problem with the opposition that the concept now supported by the administration violates generally accepted accounting principles in terms of accruals?

Mr. PEARLMAN. No; we don't think that it is inconsistent. We think while it is true that for financial accounting purposes present value is mandated, indeed we indicate that we think that that is a conceptually accurate analysis, that what the accountant and a particular company does in terms of adjusting an erroneous accrual for financial accounting purposes, doesn't rise anywhere near the level of complexity that will be imposed on a tax system if the IRS has to go through that same readjustment process.

Chairman RANGEL. The case law is unclear. When you talk about revenue losses, what would you base the potential revenue losses on if we did not accept the proposal offered by the administration?

Mr. PEARLMAN. Well, of course from our standpoint we fully acknowledge the case law is unclear. It is our position that the case law is incorrect and we believe it does not reflect current law. But as I indicated, we are concerned about the trend of that case law. We have made an estimate and indeed the proposal in our budget estimates that the revenue impact of our proposal today is $1.9 billion or roughly, a fraction over $600 million per year, $1.9 billion for 3 years. I think it is important to point out, however, that this is the kind of revenue estimate that is exceedingly difficult to make in an environment where courts seem to be willing to expand the all-events test. Our revenue estimate may well be significantly understated.

Chairman RANGEL. I am just assuming that the administration has taken into consideration the various pieces of legislation and proposals that a variety of industries have presented to the Congress. Do you believe, after reviewing all of the community benefits

that could come from this deduction prior to the economic performance, that the proposal that you are offering to Congress is in the best interests of sound tax policy?

Mr. PEARLMAN. Yes, Mr. Chairman, we spent a good deal of time over the last 6 months trying to develop this proposal—first, making sure we understood all the alternatives, and then trying to develop these alternatives. We spent a good deal of time trying to develop a system that would permit a present value deduction.

But we got so bogged down in trying to design a system that would work that we concluded we just couldn't do it. Therefore, we presented a proposal that we think reaches the right economic result, and does it in the most fair and most administrable way.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Pearlman, the revenue code provides that a taxpayer's choice of accounting method must clearly reflect income. If that is true, why hasn't Treasury taken steps administratively to insure that accrual basis taxpayers discount deductions to reflect present value? And to what extent do the code provisions currently require the accrual method people to reflect the present value of these deductions?

Mr. PEARLMAN. It may well be that if Congress were not to act this year in this area that either the clear reflection of income principle that you articulated, or a stricter reading of the all events test that looks to the specificity of the liability much more than the Ohio River case and Kaiser Steel case have—could ultimately produce the result we are trying to reach.

The concern we have, Mr. Duncan, is that the court cases have not done that, and we think that where confusion has crept into the system, as the chairman indicated, it is time to make clear what the right rule is. We find support in the *Dickman* case, the recent Supreme Court case in which the dissent said it understands the concept of treating an interest-free loan as something more than having no tax consequence. *Dickman* is a gift tax case, but certainly has a relevance beyond that. The dissent in *Dickman* the issue needs to be dealt with legislatively. This is a further ratification of why we are here and why we think it is important to try to deal with these very difficult issues legislatively.

Mr. DUNCAN. Have you had a recent court decision which prompts you to come up with this proposition?

Mr. PEARLMAN. Yes; very definitely. I mentioned the *Ohio River Collieries* case decided in 1981, and the *Kaiser Steel* case decided by the Ninth Circuit Court of Appeals in 1983. So, yes, there are cases which cause us to be concerned about what the courts might do in the future.

I just don't want to leave the impression that we are throwing in the towel on those cases; that is clearly not the case. We think those cases are incorrect, but we are concerned about those cases.

Mr. DUNCAN. Why isn't the all events test, as outlined in your own regulations, sufficient in determining when a deduction is available, and how much the deduction should be?

Mr. PEARLMAN. We believe it is sufficient, Mr. Duncan, but we are concerned that the courts may not share our view, as indeed these two cases I referred to suggest. We believe that the all events

test, as we think most people have understood it during the long period of time it has been articulated in the regulations, should produce a result that does not permit a full dollar deduction for a future liability. But we are concerned by the courts not sharing that view.

Mr. DUNCAN. You said there was a problem with State regulations—for example, in reclamation, that they have strict requirements wherein that you have to show that you have the funds for reclamation in order to get a permit and all?

Mr. PEARLMAN. We view those regulations as certainly relevant to the determination of the all events test. The ability of the taxpayer to argue that the State has imposed requirements on the taxpayers is the beginning point in making an all events test examination. Indeed, that is basically what the taxpayers have argued; that the State has demanded, or the Federal Government has, that they set aside a reserve.

Where we part ways with the taxpayer is that we don't believe a State requirement that doesn't identify and quantify the time and the specific amount of the liability entails satisfaction of the all events test. So we think that is relevant. But——

Mr. DUNCAN. Can you see the conflict with the Federal and State regulations?

Mr. PEARLMAN. I understand. But I wouldn't describe it as a conflict. Business is subject to all kinds of regulation by both the State and Federal Governments. Those regulations may well require employers to plan financially for the future, to plan for liabilities that that taxpayer will have to perform in anticipation of a State requirement.

We do not believe a business that anticipation is sufficient to permit a deduction today. Indeed, if the standard were to permit that deduction today without taking into consideration the time value of money, what happens is the Federal Government, through the tax system, ends up paying that liability.

Mr. DUNCAN. But you would propose to preempt Federal and State regulations?

Mr. PEARLMAN. No. I don't think we preempt Federal and State regulations at all. What we say to the taxpayer who says to us, "But I have a liability in the future; I am not sure how much that liability is going to be and I am not sure when I am going to have to pay it"—we say to him, "Fine, when you have the liability and you have to make payment, then you are going to get your deduction."

Indeed, we are going to make sure that when you get the deduction that if you need to carry that deduction back into earlier years, so you get the full benefit of the deduction, then we are going to make sure that the tax statutes provide for that carryback.

Mr. DUNCAN. How would you handle reserves funds for reclamation, or black lung, and all the rest?

Mr. PEARLMAN. Well, conceptually if——

Mr. DUNCAN. And they are required under law to be paid into the reserves.

Mr. PEARLMAN. Conceptually, in any case in which a dollar amount is set aside on a present value basis, at least theoretically,

if people are dealing at arm's length, if a dollar has to be set into a fund, physically put in a separate fund that is out of the control of the taxpayer, what that taxpayer is willing to set aside should be roughly equivalent to the present value. Conceptually, that would reach the right result.

But that presents tremendous complexities because we don't know today—that taxpayer cannot tell us today whether the amount he sets aside in that fund will be sufficient to pay that liability or will be insufficient to pay it. He can't say precisely when the liability will be paid and the amount that will be paid.

Using your black lung case, he can't tell today when a claim will be made against that black lung fund. He can't tell what the dollar amount of the claim will be or how much it will be. So if you do adopt a rule that says taxpayers who set funds aside, physically aside, are allowed the deduction on the amount set aside, then you have establish a set of rules that requires a look back. You have to be able to look back and second guess that set aside. That is an exceedingly complicated process.

Mr. DUNCAN. In other words, if he can't say that, as long as the dollars are not recoverable by the company—I was trying to wind up my questioning, but you led on to something else—as long as the dollars are not recoverable, you still would not allow it?

Mr. PEARLMAN. No, no. I am sorry. First, I am sorry if I interrupted you. Second, I am sorry if I misunderstood your question.

If a taxpayer pays an amount today and has no right to get it back, insurance premium or amounts paid to State funds of some kind, we don't have a problem there.

Mr. DUNCAN. Thank you.

Thank you, Mr. Chairman.

Chairman RANGEL. Is this a change in the administration's position? That where an industry actually has a current liability for an event that has not yet occurred, that you don't have a problem in allowing that to be deducted? And, if so, do you require that it be discounted?

Mr. PEARLMAN. No. I don't think it is a change in the administration's position. The all events test requires that the liability be identified and the dollar amount be identified, fixed and determinable. In that case, we allow a deduction on the current value basis.

Chairman RANGEL. Were you talking about mining?

Mr. DUNCAN. Yes.

Chairman RANGEL. If the State mandates you set aside a certain amount of money to restore the land—we don't know how much it will be, but you have to do that in order to get a license to mine—you have no problem there?

Mr. PEARLMAN. We do have a problem with that. That is not a change in current position. We do have problems with that, and the reason for that is that we do not believe it meets the all events test.

As I point out, the Tax Court disagreed with us in the *Ohio River* case, but we think that case has been incorrectly decided.

Chairman RANGEL. But the person has to put that money into that account.

Mr. PEARLMAN. Are you talking about an account, Mr. Chairman, which the taxpayer gets back in the event he doesn't have to——

Chairman RANGEL. No. I am talking about where liability is definitely going to occur but the amount is uncertain as to how much it is going to be, and in order to be involved in this particular industry they have to invest a reasonable amount to assure the State and the community that they will be prepared to restore the land.

Mr. PEARLMAN. We would say in that case that the taxpayer, notwithstanding that obligation, is not eligible for a present deduction because he doesn't know how much he is going to have to pay, and he doesn't know when he is going to have to pay it. For that reason, we believe the all-events test under current law has not been satisfied.

Chairman RANGEL. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

I am concerned about the time value of money question with respect to the longer term issues, for example, the decommissioning of a nuclear plant. I understand the case you make, and I think it is relevant. The solution is not necessarily easy to find, but you identified a couple of approaches.

I would like to talk, however, about the case of land reclamation from strip mining. We have a lot of that in my State, and I am relatively familiar with how they go about it. Take a strip mine operator who opens a small pit and exposes a 20-foot seam of coal and then mines that seam and closes the pit again. If we require that operator to by law set aside money for reclamation purposes, you are saying that that operator should not be allowed to deduct it?

Mr. PEARLMAN. That is correct.

Mr. DORGAN. In the case of strip mining where it is continuous and where reclamation is continuous and reclamation follows relatively closely to the mining operation, not more than several years out, what are we really losing in terms of the time value of money? Do you have any estimates on that?

Mr. PEARLMAN. I can't give you a dollar amount, but I think the important point is that—and I think we can look to the past few years and do a present value at interest rates in the 13 or 14 percent rate, or indeed might do it even lower and come up with some fairly large numbers—I think we can be talking about substantial amounts of dollars.

I will be happy to give you an illustration of that, but I think that the amounts are not insignificant.

Mr. DORGAN. Are you saying that if the law requires that the reserve for the liability they are incurring for reclamation be a reserve that is set aside, and they can't control it; that is, money they actually put into some fund that they no longer control—will that not be deductible under your proposal?

Mr. PEARLMAN. I want to be sure we are talking about the same facts. If a miner is required to pay money, say, into a State fund, can't get it back—he puts it in and it is the State's fund at that point and the State will make sure it is used for reclamation, and he has no right to get that money back—then we would say that that is deductible, clearly.

If he is required, similarly, to open a bank account and set a reserve on his books and put it in the account, but let it sit there on his books where he will get back whatever is left when that reclamation has taken place, if there is an excess, then we would say that is not deductible.

The middle case is the case in which he puts the funds into a trust, say, in which the fact is he has no ability to get the funds out—the mine operator is physically segregated; they may show up on his books—I don't know how the accountant would deal with it, but they would be under a fiduciary limitation on his ability to use the funds. There, conceptually, if the amount he puts into the trust is present valued, then he should get a deduction.

Our problem is how do you design a system to get him to that conceptual result? If the dollar amount is what he expects to expend 3 or 4 years from now simply because he puts it into a trust, we would say, no, that is not an appropriate approach.

Mr. DORGAN. You have described two approaches to solve the problem that you see. One is allowing the deduction based on economic performance; and the other is a deduction that would be discounted to reflect the present value. And you have indicated that in the second area it would be extraordinarily difficult for the Treasury to administer and to develop the approaches to manage that.

There are some on the committee, I am sure, who will want to proceed with the second approach. I have not decided how I feel about this issue.

If this committee decided that the deduction should be discounted to reflect present value, can the Treasury administer that?

Mr. PEARLMAN. Let me say this, Mr. Dorgan: It is not surprising that there might be some interest in dealing with a couple of these areas, most specifically the mine reclamation and nuclear decommissioning area. We are aware of the interest on the committee in doing that. And, as we have indicated—a number of times in testimony we have indicated we recognize the conceptual merit of a present value deduction. We hope that over the next several days, particularly, to be trying to address those issues, to work with the committee and members of the staff to try to see if there is a way that that kind of system can be developed which is administrable.

I would not want to leave the impression this morning that it is unadministrable. I don't think it makes sense to draw that kind of line.

Mr. DORGAN. What you are saying is the first approach is preferable and the second approach is difficult. Are you suggesting that the second approach ought to be discarded because it can't be done? Or are you saying it probably can be done, but you would prefer the first approach?

Mr. PEARLMAN. We would clearly prefer the first approach. What I would hope we can do is try to have the kinds of discussions that go on between Treasury and the committee that will try to identify the issues, and let's see if there is a way that we can deal with the second approach.

Mr. DORGAN. Either approach could be accomplished—one with a little more difficulty than the other—if the committee chose either of the two?

Mr. PEARLMAN. The only reservation I have on that—when you say either approach, I presume you are talking about a present value second approach—the only reservation I have is the complexity and the resulting inadministrability, and that is a significant one, but we want to talk further about that.

Mr. DORGAN. Just one other observation. I don't mean to hoist you on a stake, but particularly with respect to the strip mining where reclamation follows mining relatively closely, at least in my part of the country it does, because we have coal seams that are relatively close to the surface and not very thick so reclamation comes along quickly when the coal is exhausted.

The only reason you would have great concern about the time value of money is if you have substantial inflation, I assume?

Mr. PEARLMAN. No, no——

Mr. DORGAN. Generally speaking, if the value of money doesn't change substantially, you don't have great concern about it, do you?

Mr. PEARLMAN. I don't think that is right. There is more involved than that in the time value of money.

What we are talking about is having a dollar today that the taxpayer can earn a return on, and maybe a higher return because of inflation or lower return because of deflation. We would be concerned with that return value without regard to the inflation in the economy.

Mr. DORGAN. I understand. But with respect to the committee, as we have experienced it in recent years, in the last 10 years to 12 years, with inflation playing a substantial part in determining the value of money, I assume this gives rise to part of your concern especially with respect to the long-term expenses, such as decommissioning of a nuclear plant.

Mr. PEARLMAN. I would say this, Mr. Dorgan: To the extent there is inflation which will produce higher interest rates, obviously the time value of money issue becomes more significant. So, in that regard, yes, the issue will be more troubling if present value amounts will have to be determined on a higher interest rate.

But I don't want to leave the impression that if there is no inflation we are not concerned about time value of money principles. That is not the case.

Mr. DORGAN. What I was going to say—and I won't deal with it much more—is that with the suggestion in our budgets, including the outyear budgets, of substantial deficit spending and the prediction that accompanies that substantial deficit spending of lower and lower interest rates on Treasury bills, I think there are some interesting conflicts in the way we perceive various things.

Mr. PEARLMAN. Mr. Dorgan, I may be able to respond now to the questions you asked earlier about the short-term reclamation.

If we have a mining reclamation situation in which—excuse me—in which the reclamation occurs about 4 years after the time that you have the deduction, then our estimate is that there will be a 36-percent overstatement in the deduction over a 4-year period.

So, put another way, you would have the Government paying, if you assume a 50-percent tax bracket, about 68 percent of the cost.

Let me also mention as a followup to your earlier question about whether the Treasury could administer a present value system—we

are concerned about the mining reclamation expense or the nuclear plant decommissioning expense which is mandated by a regulatory authority. That is what causes us to want to pursue whether there is a way to deal with the present value issue.

I don't want to leave the impression that a present value system applied across the board would be acceptable. I think we would be able to demonstrate to you that the revenue impact, sheer revenue loss of saying to all taxpayers that as long as you the present value deductions it is OK, even if it is conceptually perfect, would produce a revenue impact in the short term which would be unacceptable.

Mr. DORGAN. You sometimes get the feeling this entire tax system is crazy?

Mr. PEARLMAN. Yes; I have had that feeling.

Mr. DORGAN. Thank you.

Chairman RANGEL. Mr. Thomas.

Mr. THOMAS. With that as a lead-in, Mr. Chairman, I want to pursue this inflation question and your concept of the time value of money, especially in light of the last 5 years, 6, with our inflation rate from 6 to 12 to 3, interest rates from 12 to 20 to 12.

What is the factoring figure and how do you anticipate or deal with inflation in the time value of money concept?

Mr. PEARLMAN. Well, I——

Mr. THOMAS. Because I don't understand it.

Mr. PEARLMAN. I am going to take your question as a mechanical question.

How is a taxpayer going to deal with these rules? Is that what you mean?

Mr. THOMAS. Yes.

Mr. PEARLMAN. Our rule, which is the strict rule, is very easy to deal with. The taxpayer simply won't get a deduction until the service that he is committed to perform, the expense he is committed to incur, for example, the reclamation occurs, the decommissioning occurs. He simply won't get a deduction until that event. So you don't have to worry about time value, if you will.

The mechanics is deferral of the deduction. The only complexity under this system is what if he takes the deduction in 1991 and doesn't have any taxable income in 1991? The system will permit a taxpayer to carry that deduction back into earlier years where he did have income. But that is a relatively simple thing. Carrybacks have been in the code for years.

If you move to a present value system such as Mr. Dorgan and the chairman were suggesting, then you introduce much greater level of complexity, and what we would have to do under that system is specify—the IRS would have to specify that in 1984 there would be a certain discount rate used and say that if you have a million-dollar claimed liability to be paid in 10 years, that in calculating the present value of that liability you will use a discount rate of x percent or the Treasury bill rate, or something.

Then the taxpayer will have to take that number and apply it to his deduction, and make the calculation on the present value, and set the dollars aside using that present value calculation.

Mr. THOMAS. In determining the discount rate, you are doing what we try to do in the budget process, anticipate what tomorrow will bring in terms of inflation?

Mr. PEARLMAN. Absolutely.

As we know in the budget process, we are not going to be right.

We know either a taxpayer is going to underestimate his expense and be eligible for an additional deduction in the future or overestimate his expense and be responsible to recapture some of the deduction that he took earlier that was improper.

Mr. THOMAS. Recent history, there has been a case of normally over or under?

Mr. PEARLMAN. That is probably right.

In an inflationary economy taxpayers may well find themselves understating the deduction.

We just don't know.

Mr. THOMAS. The cases that you feel were decided incorrectly, from the information I have, *Kaiser Steel* v. *United States*, are you appealing that case?

Mr. PEARLMAN. I am sorry. We will have to get you a response to that.

Mr. THOMAS. If the United States lost and you thought it was incorrect, I assume you are appealing it.

Mr. PEARLMAN. Normally. Appeals of tax cases to the U.S. Supreme Court are few in number and there are unwritten standards as to when the Court will take a tax case.

Mr. THOMAS. If you have gone so far as to suggest we have to change the Tax Code, I would prefer you try all prior remedies from our end, looking back to the Court.

Mr. PEARLMAN. We will have to follow up on that, Mr. Thomas. I don't know whether the case has been appealed or if it has not.

Mr. THOMAS. On page 2, you briefly outline the bills before us, and you indicated that you are not going to address them in specific details but you will get detailed statements to the committee.

I have some concern on H.R. 4859. In dealing with the question of medicare and medical expenses, this committee has attempted to hold the line on costs in a number of areas, in terms of hospital costs, and diagnostic group concepts.

I heard recently physicians are being expected to freeze their fees in this area.

I am trying to pursue another area of cost savings, and that is, since insurance premiums are currently deductible and they have gone up in the area of malpractice insurance, some doctors, especially in California, even with the support of the California Legislature, have talked about creating a trust in which the insurance premiums are significantly lower or the cost is significantly lower, but if you can deduct insurance premiums and you can't deduct contributions to the trust, there is a relative tax advantage and what H.R. 4859 tries to do is create a bit more level playing field in this area.

My understanding is that Treasury has looked at this bill and you have no objection to it, is that correct?

Mr. PEARLMAN. That is correct, Mr. Thomas.

This bill, as you know, was introduced in a prior version in early 1983. We did have the opportunity to look at it. We did have an

opportunity to make some comments regarding that bill to your staff and we appreciate the opportunity that you gave us to do that. H.R. 4859 was introduced earlier this month and reflects the concerns we have.

We think this bill does not raise time value of money problems that are inconsistent with our premature accrual concept because it involves only cash payments and for that reason, we are not in opposition to the bill.

Mr. THOMAS. I have some written testimony I would like to submit for the record with unanimous consent, and whether it is appropriate to insert it now or following panel seven, which speaks specifically to this.

Chairman RANGEL. Without objection.

Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Secretary, I want to inquire about the proposal that I put forward concerning nuclear decommissioning. Are you familiar with that proposal?

Mr. PEARLMAN. Yes.

Mr. GIBBONS. As I told Secretary Chapoton the other day, since I am now 64 years old, I see things a little differently than I used to. I have had a feeling that we have been pushing, off into the future, too many things that we ought to be funding right now.

We are pushing off a huge national debt, huge pension liabilities, as well as social security liabilities on the future generation.

That is what motivated me to introduce the nuclear decommissioning bill.

We have some 80 of these plants in existence, on line operating. By the end of this year, we will have 95 operating.

It will probably cost more in constant dollars to decommission them, I guess, than it will cost to build them.

The question arises then, who should pay for the decommissioning? The current users of the plant, which to me would seem to be the most equitable, or the future, the young people, our grandchildren who won't get any use or benefit at all out of the plant?

I realize we get into the time value of money and who is going to hold the pot and how much the decommissioning charge is, but I think we ought to prepare now for what is inevitably going to be a very difficult and very expensive job.

I don't know what it would cost. I don't think anybody on the Earth knows what it will cost, but it seems to me that we ought to set aside an amount of funding now and require the consumer or the users to ante up their costs.

Why can't we work this thing out some way?

Mr. PEARLMAN. Well, let me give you two responses. First, let me try to respond to your specific question and that is, why can't we work it out. Maybe we can.

Our principal concerns with H.R. 2820 are twofold. First, the bill does not provide for a present value calculation for the deduction and it has no provision for recalculating in the event the expense is over or understated.

I would hope, and as I indicated a few minutes ago, that if the committee decides that it wants to deal with the nuclear powerplant decommissioning expense by providing for a present value-funded arrangement, that we will be able to work something out

that is administrable and produces an economically sensible tax result, so I hope we can work it out, Mr. Gibbons.

Mr. GIBBONS. I would like to sit down with whoever is going to do the work in your shop over there and see if we can't work out something.

Mr. PEARLMAN. Let me make one other comment that I think, doesn't really go to our proposal, but it does go to the comment you made.

One of the things we should all keep in mind is that the State regulator, I presume, and obviously the ultility, will want to try to bear as much of that cost up front as it prudently can through charges to ratepayers.

Giving the utility a tax deduction in what we think we can demonstrate and which most people acknowledge is an overstated amount, at least economically, does not locate an incentive for passing the cost on to the ratepayers.

It permits utilities to pass a larger percentage of the cost on to the Federal Government in the form of a tax deduction.

Mr. GIBBONS. I understand that, and it is like a dog chasing its tail. We are all the same people, but obviously there is not going to be an incentive to set up these accounts unless there is some tax deduction.

There is not any incentive to set reserves up. We have got to start doing it somewhere or else we are going to dump the whole thing on the people who get no benefit at all for the relatively inexpensive power that is now being delivered from these nuclear plants.

We are going to make people who are not even using the electricity pay for our costs.

The taxpayer, the utility, the consumer, we are all roughly the same people over and over again. We have to have some good public policy of getting rid of these very uniquely hazardous problems that come up connected with this.

We now have 80 of those plants on line and by the end of this year, we will have 95 on line and some are about ready to start decommissioning very soon.

Mr. PEARLMAN. Mr. Gibbons, we are interested in discussing the decommissioning situation more, and we will make sure that we communicate with you.

Chairman RANGEL. Mr. Pearlman, we appreciate the administration's kind offer to work with staff to see whether we can come up with some answers and recommendations to the full committee. I assume that included in that offer would be the possibility of changing the carryback rules if in fact the staff and the members are leaning toward your initial recommendation of economic performance, as it relates to mining and nuclear expenses.

Mr. PEARLMAN. Yes, we are quite prepared to discuss the details of the carryback rules.

Chairman RANGEL. In terms of a timeframe, I have been advised by staff that the chairman of the full committee has put us on a pretty fast track. Would Monday be too early to start these discussions?

Mr. PEARLMAN. We expect it is going to be a long weekend, and we intend to begin those discussions this afternoon, and I would

hope by Monday that we would be able to give you some indication of the direction of the discussions.

Chairman RANGEL. Well, if you can exchange the telephone numbers, you can start to work next week, I am certain the full committee is very anxious to look at what we can do in this area, if anything.

Chairman RANGEL. The Chair would like to call out of order Don Bailey, Counsel to the National Coal Association, a former member of this committee; the Mining and Reclamation Council of America, Dwight Keating; the National Coal Association, Joseph E. Nicholls, Jr.; and Dennis P. Bedell, American Mining Congress.

STATEMENT OF DON BAILEY, COUNSEL, NATIONAL COAL ASSOCIATION

Mr. BAILEY. I want to express my gratitude for the chairman taking us out of order. I do have to be in Philadelphia very soon.

I have a brief statement that I would like to read to you.

My name, for the record, is Don Bailey, and I am an attorney practicing in Greensburg, Pa., and appearing at the request of the National Coal Association.

I appreciate this opportunity to present my views on a subject that is of great interest to me. As a member of the House Ways and Means Committee, my concern was demonstrated by the fact that I introduced the Mining and Reclamation Act of 1981. I am gratified that my good friend Ronnie Flippo has taken up the task of attempting to correct what I believe is an abuse of administrative discretion by the Internal Revenue Service, by introducing his bill, H.R. 3342, to permit the accrual of reserves for reclaiming surface-mined land.

The intent of Mr. Flippo's bill, as was my intent, is to clarify existing tax law and to eliminate any question that an accrual basis taxpayer is entitled to take current deductions for estimated future reclamation expenses when complying with the surface mining reclamation requirements of both State and Federal law. Current case law under the Internal Revenue Code and technical IRS rulings highlight the contradiction and ambiguities conerning the right of surface mining operators on this point.

Under the accrual method of accounting, an expense deduction generally cannot be taken until all the events occur which determine the fact of the liability and the amount of the expense can be determined with reasonable accuracy. For surface mining operators, the liability exists as a consequence of the reclamation requirements imposed by the Surface Mining Control and Reclamation Act of 1977 and many State-enacted reclamation laws. When a surface mining permit application is made, a reclamation plan is included and reviewed by a State regulatory body or the Federal Office of Surface Mining.

This reclamation plan must be approved before an operator permit is issued. Both the requirement and the plan are sufficiently detailed to demonstrate the existence of a future obligation once the strip mining begins, and thus an expense liability eligible for deduction under generally applicable tax rules. For a taxpayer using the cash method of accounting, these reclamation expenses

may be deducted when paid. For accrual method taxpayers, however, the law is unclear as to when they can deduct the expenses. In H.R. 3342, expenses in the form of additions of a reserve may be deducted in the year in which all events have occurred which determine the fact of liability and the amount is determinable without reasonable accuracy.

At the expense of sticking my neck out, Mr. Chairman, I do believe the gentleman from Treasury indicated a conflict on this issue. I don't think there is too much as far as courts are concerned. Particuarly in the cases dealing with surface mining, but there is a conflict between IRS interpretation, their rules, and not so much in the case law area.

Unfortunately, the IRS has issued technical rulings disallowing what should be eligible deductions. Their position is that an accrual basis taxpayer cannot deduct an expense for performing a service prior to the time the service is performed, primarily because until such time the taxpayer has merely agreed to become liable in the event the future services are performed.

Standing alone, the argument is certainly plausible and easily defended. I believe, however, that this position is at variance with the Federal reclamation requirements imposed on surface mining operators as a condition of doing business. What the IRS has called a stage of agreeing to become liable is, in reality for our taxpayers, a time of incurring actual expenses and responding to legal and financial obligations. These obligations and requirements, particularly the requirement that operators post a surety bond to insure reclamation, have been found to satisfy the "all the events test" of the Internal Revenue Code regulations determining the eligibility of accrual deductions.

As held in the U.S. Tax Court decision of *Ohio River Collieries Co.* v. *Commissioner*, a reclamation law requiring the estimation of reclamation costs and the posting of a surety bond, as in Ohio, insures that reclamation will occur following the intended strip mining. The reclamation is a certainty once strip mining begins, not as event of some doubt. And, as such, a liability is incurred when an operator meets the reclamation requirements, is issued a permit, and commences strip mining.

The Tax Court's decision in *Ohio River Collieries Co.* v. *Commissioner* generally follows the line of argument behind H.R. 3342. Like the court, this bill has addressed the question of what constitutes a qualified reclamation plan and a reasonably accurate estimate of expenses by focusing on the requirements of the Surface Mining Control and Reclamation Act of State requirements that are substantially similar. In many States, of course, more stringent reclamation requirements are imposed on operators.

With respect to the reasonable accuracy of estimated expenses, I believe that the requirements of the reclamation plan itself include factors that bear on the accuracy and reasonableness of the estimated expenses. In the *Ohio River* case, both parties stipulated that the expenses were reasonably estimated. This suggests to me that State officials, the IRS, and operators would not quarrel with our view that reclamation plans contain sufficiently detailed information for estimating the extent of future reclamation costs and thus the extent of the liability incurred.

Mr. Chairman, on this estimation issue, and I would again be very happy to stand corrected, IRS, in the *Ohio River* case, stipulated to the estimate.

I believe a reading of that case will show IRS stipulated as to that estimation of cost, and I think that may be slightly at variance with what the gentleman from Treasury was saying when he spoke to the committee, but I am sure he has not read the case in that much detail.

The problem this bill addresses, Mr. Chairman, is a very serious one for the surface mining industry. The mismatching of income and deductible expenses has not only led to a severe accounting problem, but also to less than optimal production decisions. This only exacerbates our Nation's energy dilemma. At minimum, the IRS should be required to follow the *Ohio River* case. In addition, cash method surface mining operators should be allowed to elect accrual accounting of their reclamation costs on a property-by-property basis and to be able to deduct their reclamation reserves from income from the sale of extracted minerals.

The fact of reclamation expense liability is a condition of surface mining. Reclamation is no longer a future event of some doubt. The IRS position with respect to accrued reclamation expenses needs to be changed and this bill provides the fairest and most reasonable approach as to when and how these deductions should be taken.

In closing, I wish to say that I appreciate the problem the subcommittee faces in its deliberations on accrual of reserves, since other industries believe, and perhaps justifiably so, that accruals should be permitted various future costs. For example, the insurance industry would like to accrue for insuring future risk losses. And also, the electric utility industry would like to accrue for the costs of decommissioning nuclear powerplants. They probably have strong arguments.

In the case of the surface miner, the fact of the liabiity is certain. It begins when the first shovel of overburden is removed. The liability exists because Federal and State law says it exists. Finally, in the case of mining, two circuit courts and the U.S. Tax Court have agreed that liability is certain, and that costs can be estimated with reasonable accuracy.

I want to add as a postscript again, IRS has stipulated to that issue in the *Ohio River* case.

Again, Mr. Chairman, I appreciate your giving me the opportunity to testify before the members of the committee on specific questions.

The gentlemen with me here are far more expert than I and can help respond to the individual questions.

[The prepared statement follows:]

STATEMENT OF DON BAILEY, COUNSEL, NATIONAL COAL ASSOCIATION

Chairman Rangel, and members of the subcommittee, my name is Don Bailey. I am an attorney, practicing in Greensburg, Pennsylvania. I am appearing at the request of the National Coal Association.

I appreciate this opportunity to present my views on a subject that is of great interest to me. As a Member of the House Ways and Means Committee my concern was demonstrated by the fact that I introduced the Mining and Reclamation Act of 1981. I am gratified that my good friend Ronnie Flippo has taken up the task of attempting to correct what I believe is an abuse of administrative discretion by the

Internal Revenue Service, by introducing his bill H.R. 3342, to permit the accrual of reserves for reclaiming surface-mined land.

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Under the accrual method of accounting, an expense deduction generally cannot be taken until all the events occur which determine the fact of the liability and the amount of the expense can be determined with reasonable accuracy. For surface mining operators, the liability exists as a consequence of the reclamation requirements imposed by the Surface Mining Control and Reclamation Act of 1977 and many State-enacted reclamation laws. When a surface mining permit application is made, a reclamation plan is included and reviewed by a State regulatory body or the Federal Office of Surface Mining. This reclamation plan must be approved before an operator permit is issued. Both the requirement and the plan are sufficiently detailed to demonstrate the existence of a future obligation once the strip mining begins, and thus an expense liability eligible for deduction under generally applicable tax rules. For a taxpayer using the cash method of accounting, these reclamation expenses may be deducted when paid. For accrual method taxpayers, however, the law is unclear as to when they can deduct the expenses. In H.R. 3342 expenses in the form of additions of a reserve may be deducted in the year in which all events have occurred which determine the fact of liability and the amount is determinable with reasonable accuracy.

Unfortunately, the IRS has issued technical rulings disallowing what should be eligible deductions. Their position is that an accrual-basis taxpayer cannot deduct an expense for performing a service prior to the time the service is performed, primarily because until such time the taxpayer has merely agreed to become liable in the event the future services are performed.

Standing alone, the argument is certainly plausible and easily defended. I believe, however, that this position is at variance with the Federal reclamation requirements imposed on surface mining operators as a condition of doing business. What the IRS has called a stage of agreeing to become liable is, in reality for our taxpayers, a time of incurring actual expenses and responding to legal and financial obligations. These obligations and requirements, particularly the requirement that operators post a surety bond to insure reclamation, have been found to satisfy the "all the events test" of the Internal Revenue Code regulations determining the eligibility of accrual deductions. As held in the U.S. Tax Court decision of *Ohio River Collieries Co.* v. *Commissioner*, a reclamation law requiring the estimation of reclamation costs and the posting of surety bond, as in Ohio, insures that reclamation will occur following the intended strip mining. The reclamation is a certainty once strip mining begins, not as event of some doubt. And, as such, a liability is incurred when an operator meets the reclamation requirements, is issued a permit, and commences strip mining.

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serves from income from the sale of extracted minerals. The fact of reclamation expense liability is a condition of surface mining. Reclamation is no longer a future event of some doubt. The IRS position with respect to accured reclamation expenses needs to be changed and this bill provides the fairest and most reasonable approach as to when and how these deductions should be taken.

In closing, I wish to say that I appreciate the problem the Subcommittee faces in its deliberations on accrual of reserves, since other industries believe, and perhaps justifiably so, that accruals should be permitted various future costs. For example, the insurance industry would like to accrue for insuring future risk losses. And also, the electric utility industry would like to accrue for the costs of decommissioning nuclear power plants. They probably have strong arguments. However, their situations are quite different than that of the surface mining industry. At the end of a license period a nuclear plant may be refurbished, relicensed and go on producing electricity. The insurance companies wish to accrue for costs they might incur.

In the case if the surface miner, the fact of the liability is certain. It begins when the first shovel of overburden is removed. Unlike other industries the liability exists because federal and state law says it exists. Finally, in the case of mining, two Circuit Courts and the U.S. Tax Court have agreed that liability is certain, and that costs can be estimated with reasonable accuracy.

Again, Mr. Chairman, I appreciate your giving me the opportunity to testify before the Members of you Subcommittee this morning on this important issue. I hope my comments will help your and your colleagues as you consider the provisions of the measures before you.

Chairman RANGEL. Are there any further statements from members of the panel?

STATEMENT OF JOSEPH E. NICHOLLS, JR., MEMBER, TAX COMMITTEE, NATIONAL COAL ASSOCIATION, AND SENIOR VICE PRESIDENT, DRUMMOND COAL CO.

Mr. NICHOLLS. My name is Joseph E. Nicholls, Jr.

I am a member of the Tax Committee of the National Coal Association and a senior vice president of Drummond Coal Co. We appreciate this opportunity to express our views on the deductibility of accrued reclamation. NCA strongly supports H.R. 3342 introduced by Congressman Flippo and cosponsored by 21 other Members of the House.

As you know from the technical data submitted to your committee, the issue we are discussing today has been legally contested in our Nation's courts since the 1940's. The court history of the reclamation issue, including the 1981 Tax Court decision in the Ohio Rivers Collieries case, has sustained the coal industry's position on the tax deductibility of accrued reclamation expense. The coal industry and the Government has spent almost 40 years litigating the issue. Almost 40 years of legal and administrative costs. Since the IRS, through unilateral rulings or regulatory actions, chooses to continue court actions on the reclamation deduction, we in the coal industry believe legislative action is necessary to stop the inexcusable waste of limited economic resources by both the Government and the industry.

Under existing law, there are only two questions to be answered. Section 461(a) of the Internal Revenue Code, the section containing the so-called all events test, provides that if a liability exists in fact and it can be reasonably estimated, the taxpayer may deduct the cost associated with such liability.

Does the coal company have a liability? Obviously, we think we do. Court history supports our position. In addition, there is other Federal legislation directly covering the reclamation process that provides for the posting of bonds sufficient to assure completion of

reclamation work and, if not completed, the imposing of criminal sanctions, including up to one year in jail, on officers of the company. In addition, the financial community, specifically lenders and certified public accountants, considered reclamation a liability at the time the ground is disturbed.

The second question, can a coal company reasonably estimate the future cost of reclamation, is not only a tax issue, but more importantly, an economic issue near and dear to the hearts of the coal companies, its customers and its outside auditors. If a coal company cannot reasonably estimate reclamation costs, it will all be out of business in the very near future. Our ability to reasonably estimate and recover this cost through current revenues is essential to our long-term financial health.

In pending cases with the IRS, they have admitted that we could estimate our liability as a company.

The coal industry appreciates the efforts of the sponsors of H.R. 3342. We believe the bill will serve to reduce the conflict between the industry and the IRS. We would like to offer one change to avoid any confusion as to how the current bill would define "reasonable additions." We suggest that section 467 be amended slightly by adding language to the effect that the estimate shall be deemed reasonable if it is based on current accounting, mining and industrial engineering practices.

I would like to take a few moments to deal with two more subtle issues, funding through a qualified trust and the time value of money concept.

First, the funding issue. Coal companies must reclaim contemporaneously with their mining operations. This is a regulatory requirement and a mining economic requirement. In the case of my company, our actual reclamation cost incurred pays off our accrued liability every 6 to 9 months.

The other issue, the time value of money issue, is one that has been debated by the financial community for many years. We all recognize the value of a current dollar in hand versus one in the future. I would welcome legislative attention to this issue but not in the limited context of an accrued reclamation liability. If the time value of money issue is to be addressed, it should be addressed in the broader context of all the assets and liabilities.

In the case of my company, the excess depreciation resulting from a depreciation expense based on replacement value versus original costs amounts to $13 million per year versus a total cumulative accrued reclamation liability of $18 million. This is a financial number which we developed in the ordinary course of business and does not necessarily relate to the tax difference. However, I believe we would find that our tax depreciation would increase significantly if our assets were adjusted for the time value of money. This is a complex area and in times of high inflation a very expensive area to industry. While we would welcome relief in this area, we do not believe the concept should be introduced only when it works to the Government's benefit.

I would like to thank you for this opportunity to represent the coal industry and will be glad to answer any questions that you may have.

[The prepared statement follows:]

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STATEMENT OF JOSEPH E. NICHOLLS, JR., DRUMMOND COAL CO., JASPER, ALA., ON BEHALF OF THE NATIONAL COAL ASSOCIATION

My name is Joseph E. Nicholls, Jr., I am a member of the Tax Committee of the National Coal Association, and Senior Vice President of Drummond Coal Company located in Jasper, Alabama. We appreciate this opportunity to express our views with respect to the accrual of reclamation reserves.

The membership of the National Coal Association (NCA) consists primarily of producing coal companies, whose operations comprise over half of the production in the United States. In addition, we number in our membership equipment manufacturers, railroads, coal exporters, consultants, and other coal related industries. I am appearing today to discuss accrual of reclamation reserves which directly relates to the subject of this hearing.

NCA strongly supports the Mineral Mining Reclamation Reserve Act of 1983 (H.R. 3342) introduced by Representative Flippo and co-sponsored by 21 other Members of the House. For many years the coal industry has maintained that the accrual of costs for reclamation is proper under the Internal Revenue Code (I.R.C.). Two Federal Circuit Courts of Appeals have so ruled. In 1981, the U.S. Tax Court reversed its previous position and held that the accrued reclamation costs appears to be one of those issues that will not be a settled issue between the coal industry and Internal Revenue Service (IRS) unless specific legislation is passed.

The IRS and members of NCA have long been familiar with pertinent court cases which we believe supports the coal industry's position on the deductibility of accrued reclamation costs. However, the coal industry continues to incur legal, accounting, engineering, and incremental in-house costs to counter IRS adjustments disallowing the accrual of reclamation costs. In Septermber, 1982, my company received a notice from the IRS disallowing our reclamation costs deduction. Not only is my company now incurring additional costs but so will the government, i.e., IRS, courts, etc. This is an inexcusable waste of economic resources needed to capitalize industry and operate our government.

ISSUES

My testimony will address whether costs for reclamation meet the requirements of I.R.C. Section 461(a) as interpreted by Section 1.461-1(a)(2) of the Income Tax Regulations in the year the land is disturbed and are these costs therefore, deductible in that year by an accrual basis taxpayer ("Current Law") and the proposed bill.

CURRENT LAW

Facts

Coal mine operators are mandated by both federal and state law to restore land that is disturbed by the mining process. The Federal Surface Mining Control and Reclamation Act of 1977, Public Law 95-87, (hereinafter referred to as the Federal Reclamation Act of 1977) provides that prior to receiving a mining permit each mine operator must submit and receive approval of a reclamation plan which complies with both federal and state law. Pursuant to Section 509(a) of the Federal Reclamation Act of 1977 each mine operator is required to furnish a bond in an amount "sufficient to assue the completion of the reclamation plan if the work had to be performed by the regulatory authority in the event of forfeiture." Note however, that while bonding figues are reasonably accurate, they do not reflect the actual costs and should not be used as a standard for accrual purposes. In addition, this federal statute requires that the states impose criminal sanctions including jail sentences of up to one year for willful failure to meet statutory reclamation requirments.

A mine operator's obligation to reclaim the land becomes fixed immediately when the land is disturbed. Simultaneously, with the removal of dirt from the seam of coal, the mine operator incurs the obligation for reclaiming the land disturbed by removal of the dirt. For book purposes a mine operator must match the expense of reclamation to the disturbance of the land and the related liability to reclaim the land. Therefore, in conjunction with the creation of the obligation for reclamation the mine operator accrues on his books the costs which will be required in order to reclaim the land which has been disturbed as a result of mining operations. Not only direct reclamation costs, but all mime closing expenses should be permitted to be accured. These include work required by federal and state law, such as removal of buildings and equipment, the disposal of refuse and the restoration of roads. Also included are the maintanance of air and water quality. With respect to maintenance

of water quality, the costs of the function could continue on for years after the mine is closed.

In addition to accounting requirements, several other factors have required the development of reliable and precise engineering techniques to ascertain the costs which will be incurred to reclaim disturbed land. Escalation clauses of many long-term sales contracts permit adjustments in the sales price of coal for increase in accrued reclamation cost. Such increases directly impact cash flow to the mine operator and are subject to intense audit by the coal purchaser. Additionally, as previously mentioned, the taxpayer's estimates of reclamation costs are also used to determine the amount of reclamation bonds which are required to be posted. Finally, mining operators, as purdent business persons, must know what the actual total cost of mining a ton of coal on a current basis is, including reclaiming the land from which the coal was mined, in order to compete in today's highly competitive environment.

Law

Section 1.461.1(a)(2) of the Regulations provides a two part test, which is to be used by an accrual basis taxpayer in determining the timing of a deduction. This section of the regulations provides that a taxpayer shall deduct an expense in the taxable year in which: (1) All events have occurred which determine the fact of the liability; and (2) The amount of the liability can be determined with reasonable accuracy.

We believe that accrued reclamation costs meets both of these tests for the taxable years in which the land to be reclaimed is disturbed. For purposes of discussion we will address each of these tests separately.

It is our contention that the first of these tests is met each time the land is disturbed and that it is met immediately when the land is disturbed. Pursuant to the requirements of both federal and state law a coal mine operator has a requirement to reclaim all land disturbed in the mining process and that requirement occurs when the land is disturbed.

The U.S. Tax Court in *Ohio River Collieries Co.* v. *Commissioner,* 77 TC No. 103, 12 81, reversed its earlier positicn in *Harrold* v. *Commissioner,* 16 TC 134 (1951), revd. 192 F.2nd 1002 (4th Cir. 1951) and is now in concert with the Circuit Courts in regard to satisfaction of the all events test for reclamation liabilities. In *Ohio River Collieries,* the taxpayer accrued on its books and claimed as a deduction for federal income tax purposes the estimated cost of reclamation work required by Ohio law but not accomplished by the end of the taxable year. The government concluded that the taxpayer's statutory duty to reclaim did not create any liability to pay and that therefore the estimated costs was not deductible. The court, citing the Ohio law requirement for a strip miner to estimate his reclamation cost and post a surety bond to cover it, held that once strip mining occurs the liability becomes certain and thus the all events test is satisfied.

Previously the 4th Circuit, upon appeal of *Harrold,* also held that all events necessary to determined the liability occurred in the year that the statutory obligation to reclaim was imposed on the operator. The court was presented with the situation where the taxpayer was required by the law of the State of West Virginia to reclaim the land where the taxpayer had stripmined. The taxpayer deducted the cost to reclaim the land in the year the land had been mined (1945) and the government contended that expense of reclamation work was deductible in 1946 the year the reclamation as performed. In deciding that the reclamation was properly deductible in 1945 (the year the mine was tripped) the Fourth Circuit adopted the approach which has since been widely followed by the courts. It held that the reclamation activity itself was not a prerequisite for deductibility. The court found that "all the facts have occurred which determined that the taxpayer has incurred a liability in the tax year" (in which the operator became obligated by statute to reclaim the disturbed land). The court went on to say that to permit a deduction in the year in which the statutory obligation attached to the mine operators "allocates to each year the proper income and expense and prevents distortion of the taxpayers financial condition in the tax year."

Denise Coal Co. v. *Commissioner.* 271 F.2d 930 (3rd Cir. 1959) also addressed the question of the year of the deduction for accrued reclamation expenses. In *Denise* the taxpayer was required by Pennsylvania law to reclaim land which it had stripmined. The taxpayer estimated the costs of reclaiming the land on which it mined and deducted the cost in 1948 even though the actual reclamation activity was not completed until 1956. The court citing *Harrold* approved the deductions in the year the mine operator became obligated by statute to reclaim the land. In so holding for

the taxpayer the court stated that the "Pennsylvania statute imposes a fixed and definite obligation."

The conclusion that the liability for reclamation was fixed in the year that the statutory obligation is imposed was also accepted in *Commissioner* v. *Gregory Run Coal Co.* 212F.2d52 (4th Cir. 1954), Cert. denied 348 U.S. 828 (9154) and *Patsch* v. *Commissioner,* 208F.2d532 (3rd Cir. 1954). Both of these cases involved the question of the proper year of deduction for reclamation expenses accrued by coal mine operators. In both these cases, however, the deduction for the reclamation was denied because taxpayers based the estimate of the amount of the liability on arbitrary and untested rules of thumb and therefore failed to met the "reasonable accurate", test prescribed in part two of Section 1.461-1(a)(2) of the Regulations.

Prior to Ohio River Collieries, the Tax Court had already indicated its approval of the reasoning of the *Harrold* and *Denise* decisions in *World Airway, Inc.* and *World Air Center, Inc., Petitioners* v. *Commissioner, of Internal Revenue, Respondent,* 62 TC 786 (1974). The Tax Court in *World Airways,* denied the taxpayer a deduction for an accrual to overhaul aircraft engines at some time in the future. In denying the deduction the Tax Court distinguished *World Airways,* from *Harrold,* and *Denise,* saying that in the *Harrold,* and *Denise,* cases the "accruals were allowed because in the taxable years in which the deductions were taken, there had occurred all the *operative* facts giving rise to the obligation to restore the stripped land."

The position of the court in *Harrold,* that it is not necessary to actually perform the work in order to be permitted a deduction has been adopted in a number of other decisions outside the area of reclamation as follows:

(1) In *Scheussler* v. *Commissioner,* 230F.2d722, (5th Cir. 1956), the Fifth Circuit permitted an accural method taxpayer to deduct in the year of sale the estimated cost of turning on furnaces each year for a period of five years. This case involved a situtation where the taxpayer incurred the obligation to turn the furnace off and on for a period of five years at the time the furnaces were sold.

(2) In *Pacific Grape Products Co.* v. *Commissioner,* 219F.2d862 (9th Cir. 1955), the Ninth Circuit allowed a seller of food products to deduct in the year of sale, the cost of packaging, and shipping products which had been sold even though the shipping and packing had not been performed.

(3) *Gillis* v. *United States,* 402F.2d501 (5th Cir. 1986) involved a situtation where as a condition of being permitted to purchase cotton at an artificially low price from a government agency, the taxpayer was required to export an identical amount of cotton at a price below the market value. The court decided that the taxpayer correctly recognized the loss, which would be incurred on the sale of the cotton, in the same years the gain on the purchase was recognized.

The current position of the Internal Revenue Service is apparently set out in the National Office Technical Advice Memorandum 7831003. The Tax Court in *Ohio River Collieries,* has now clearly stated its position that once strip mining occurs the liability to reclaim, pursuant to applicable law, is fixed. Furthermore, there is only one non Tax Court decision since *Harrold,* cited in this Technical Advice as support for the position that accured reclamation does not represent fixed liability. The sole case is *Schlude* v. *Commissioner,* 372 U.S. 128 (1963); which involves prepaid income, and the question of the year of inclusion of prepaid income is easily distinguishable from the question of the year of deduction of accured expenses.

The second part of the test under Section 1.461-1(a)(2) of the Regulations is that the amount of the liability must be determined with *reasonable* accuracy. We submit principles, the coal mine operators are able to compute the amount of accrued reclamation expense with a relatively high degree of accuracy. To avoid any confusion as to how to define reasonable accuracy we suggest that it be made clear that the estimate shall be deemed reasonable if it is based on current accounting, mining, or industrial engineering practices.

The Fourth Circuit, in *Harrold,* stated that a liability which meets the all events test in deductible if the amount of the liability "although not definitely ascertained is susceptible of estimate with reasonable accuracy in the tax year." The approach of permitting a reasonable estimate, as opposed to requiring the reclamation activity be complete and the actual cost per unit be known, is the interpretation virtually all courts have applied to the phrase "determined with reasonable accuracy" as it is used in Section 1.461-1(a)(2) of the Regulations. We submit, therefore that the taxpayers have determined the amount of the liability for reclamation with reasonable accuracy.

CONCLUSION

Based on the authority, the taxpayers believe that the liability for reclaiming the acres disturbed as of the end year in question is both fixed and determined with reasonable accuracy.

While we believe the existing body of law, including two Federal Courts of Appeals cases and the recent U.S. Tax Court case, is clear, the IRS is not ready to accept it as the law. The IRS' National Office Technical Advise Memorandum (#7831003) states:

"It is acknowledged that the reasonable estimate doctrine of Harrold has been followed in subsequent coal reclamation decisions. It is also acknowledged that the premissibility of reasonable estimates has not been confined to the third and the fourth circuit or has it been limited to reclamation expenses situations. However, the service has not indicated that it will follow either the rationale employed or the holdings of any of the above cited decisions."

Based on the Service's actions to date, it appears their strategy is to continue disallowing accrued reclamation deductions hoping to find a friendly court. This process has been and will continue to be expensive to both the coal industry and the Government. This is documented in a letter the National Coal Associations received from the IRS earlier in the year, a copy of which is attached to this statement.

We believe the course chosen by the IRS is not only ill-advised but very expensive to the Government. Consider that gross accrued reclamation costs adjustment also have offsetting adjustments: Coal inventory value would be reduced; allowed percentage depletion deductions would increase; gross sales amounts of certain of our members would be reduced; and taxpayers expenses increases to legally challenge the reclamation issue.

In the case of my company, the IRS has disallowed a cumulative $9.5 million for accrued reclamation costs. We are at various stages of protesting the disallowances. My best estimate of our offsets would reduce the IRS' cumulative disallowances to $5.5 to $6.5 million (60 percent to 70 percent) should it prevail in its position. I think it is worth noting that the $9.5 million represents only 5 to 6 months of actual reclamation cost expenditures (cash basis) and reclamation costs, in the aggregrate, are over 6 percent of our production costs.

There is also an equity factor that should be considered when dealing with reclamation. The minimum period in which cash expenditures are incurred for reclamation activities after the closure of a mine is five years. Existing tax law provides for a carry-back of net operating losses to the third preceeding year. The probability of having taxable income from a closed operation in nil. Therefore, coal companies will permanently lose some portion of their reclamation costs as a tax deductible expense if a cash basis accounting is required.

NCA members believe that the existing body of law supports the deduction of reclamation expenses on the accrual basis and if we were willing to wait for the legal conflicts with the IRS to be resolved in either the Federal Courts or the Tax Court, the coal industry would continue to prevail in its position. However, the ever mounting nonproductive costs to the coal industry and the Government, and the interaction with other areas of coal company operations such as finance brought about by the uncertainty has led us to conclude that legislative action is necessary.

May I suggest one small item that we think would improve the bill by making it equitable as between strip and deep mining. H.R. 3342 deals with land reclamation required as a result of the extraction of minerals by surface mining activities. The Surface Mining Control and Reclamation Act of 1977 also requires restoration of the surface land which is disrupted as a result of underground coal mining. There is really no practical difference between the two types of expenses and we believe they should be covered in any legislation dealing with the problem.

We appreciate this opportunity to present our views on this vital legislation. We urge your favorable consideration of H.R. 3342.

Chairman RANGEL. Thank you. Mr. Keating.

STATEMENT OF DWIGHT KEATING, VICE PRESIDENT OF FINANCE, GRAFTON COAL CO., ON BEHALF OF THE MINING AND RECLAMATION COUNCIL OF AMERICA

Mr. KEATING. I am vice president of finance with Grafton Coal and represent the Mining and Reclamation Council of America, which primarily represents many medium and small companies.

I would like to address a couple of issues the Treasury has mentioned today.

First of all, the time value of money: Under the Federal law it is required that reclamation be as contemporaneous as possible. In West Virginia, State law, reclamation must occur within 1 year of the mining.

As a consequence, the time value of money argument is insignificant in this regard.

Also, our reclamation reserve estimate is based upon sound engineering practices and is calculated in current dollars. It is not based on future estimates of what the cost is going to be. It is on present value of what those costs are.

It would be very interesting to hear Treasury's view; if we did not have a reclamation reserve, on our reported profits which would be larger as a result of our percentage depletion allowance being larger. I wonder if they have balanced that into their calculations and what the potential revenue loss would be; that is, the overstating our profits could equal to the revenue loss from time-value of money issue.

Lastly, the general rule that Treasury suggests could really penalize the small operator. In many instances in the East, the Appalachian mines, the small operator posts a bond which is actually cash or collateral and that cash is released over a 5-year period after reclamation is completed.

If he is not getting any type of cash benefit until that cash is released, he could be putting up twice as much capital over a 5-year period than actually would be needed, and he would have a very serious cash flow problem.

[The prepared statement follows:]

STATEMENT OF DWIGHT KEATING, GRAFTON COAL CO., CLARKSBURG, W.VA., ON BEHALF OF THE MINING AND RECLAMATION COUNCIL OF AMERICA [MARC]

Mr. Chairman, members of the subcommittee, I am Dwight Keating, vice president of Grafton Coal Company, Clarksburg, West Virginia. I appear before the subcommittee today on behalf of the members of the Mining and Reclamation Council of America [MARC]. MARC is a national trade association representiong domestic surface coal producers from all coal producing regions of the United States. Through its corporate and affiliate membership, MARC represents over 70 percent of the coal produced in the United States last year.

MARC requested to appear today to urge the subcommittee to recommend committee enactment of legislation to codify the right of a surface coal operator to deduct the costs of reclamation in the year in which the liability arises. Legislation, H.R. 3342, the Mineral Mining Reclamation Reserve Act, and S. 237, the Comprehensive Mining Reclamation Reserve Act, to codify the legal right, was introduced in both the House and the Senate in the first session by Representative Flippo and Senator Wallop respectively.

This legislation would codify the existing judicially recognized right of a surface coal operator who uses the accrual method of accounting to deduct the cost of reclamation in the taxable year in which the liability arises. The existing legal right of a taxpayer to elect such tax treatment was recognized most recently in a unanimous decision of the U.S. Tax Court in December 1981. In *Ohio River Collieries Company* v. *Commissioner*, 77 T.C. No. 103, December 31, 1981, the Tax Court, in applying applicable law and regulations,[1] held that if all the events had occurred that deter-

[1] Section 461(a) of the Internal Revenue Code states the general rule that a taxpayer is allowed a deduction in the "the taxable year which is the proper texable year under the method of accounting used in computing taxable income," and the regulations elaborate on this general provision. For accrual basis taxpayers, section 1.461-1(a) (2), provides:

Continued

mined the fact of the liability and the amount of the liability was determined with reasonable accuracy, the taxpayer may deduct its accured reclamation costs in the year the liability arises. The Government did not appeal the Tax Court's decision.

In light of this existing legal precedent, and decisions in two Federal judicial circuits [2] upholding the right of a taxpayer to take this deduction, one may wonder why it is necessary to enact this legislation. The reason is, in spite of a clear holding by the Nation's primary tax tribunal, and two Federal circuit courts, the Treasury Department and the Internal Revenue Service continue to contest [3] the legal right of a surface coal operator to take this deduction in the year the liability arises. Mr. Tony Gentile, the president of Ohio River Collieries Company, the petitioner in the Tax Court decision and a former chairman of MARC, incurred substantial costs [4] in legal fees, in the allocation of employee time, and in lost use of the amount of the disputed deduction for several years in establising his legal right to the deduction. Similar unnecessary costs will continue to be incurred by coal operators and the Government, in contesting the deduction, if legislation is not enacted.

These costs are particularly onerous for smaller operators who most often do not have in-house legal and accounting personnel but must cntract for such services. Most smaller operators sell their coal in the highly price competitive spot market for coal; not under long term contracts. As a consequence, these unnecessary costs, which must be paid out of net oprating revenues, resulting in decreased income and cash flow constraints for the operator.

Mr. Chairman, absent enactment of this legislation, coal producers will continue to be forced to incur these expenses and the accompanying aggravation to take a deduction clearly allowed under law. Although the Treasury Department has been requested to revise its policy to make it consistent with judicial interpretations and its own regulations; Treasury has given no indication that this policy will be modified. As a consequence, unnecessary costs will continue to be incurred by both coal operators and the Government.

With respect to the pending legislation, Mr. Chairman, I submit the following points for your consideration.

Under applicable law and regulations the question of the accrual and deduction of reclamation expenses is twofold. First, the fact of the liability to reclaim the land must be fixed. The opinion of the tax court in the *Ohio River Colleries Company* v. *Commissioner* clearly concludes that all the events establishing the fact of the liability to reclaim the land are fixed once the land is disturbed. The requirements of the Federal Surface Mining Control and Reclamation Act of 1977 [SMCRA] impose a fixed liability which must be secured by a bond or other evidence of financial capability on all coal operators.

Several States have had a similar requirement for a longer period. In my State, West Virginia, the liability has been in place since the 1960's. The pending legislation would statutorily recognize the fact of this fixed liability established by the Surface Mining Control and Reclamation Act [SMCRA] in 1977 for all coal operators nationwide.

Second, the amount of the liability must be determined with reasonable accuracy. In the *Ohio River Collieries* case the IRS stipulated the reasonableness of the Reclamation estimate. It is unlikely that such stipulations will be regularly made. To avoid unnecessary litigation and reduce administrative burdens on the IRS, operators, and the judicial system, I would recommend that either the legislation incorporate a definition of reasonable or that guidance be provided in the legislative history. For example, language which provided that the estimated expenses of surface

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Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy . . . While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

[2] *Harrold* v. *Commissioner*, 192 F. 2d 1002 (4th Cir., 1951) and *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930 (3rd Cir., 1959) upheld the right of a taxpayer to deduct accrued expenses for reclamation work mandated under State law.

[3] Internal Revenue Service National Office Technical Advice Memorandum #7831003, April 13, 1978, states in relevant part:

It is acknowledged that the reasonable estimate doctrine of Harrold has been followed in subsequent coal reclamation decisions. It is also acknowledged that the permissibility of reasonable estimates has not been confined to the Third and the Fourth Circuit or has it been limited to reclamation expense situations. However, the service has not indicated that it will follow either rationale employed or the holdings of any of the above cited decisions.

[4] Ohio River Collieries Company incurred legal expenses of $50,000 and accounting expenses of $20,000 in establishing its right to take the disputed deduction.

mining land reclamation would be deemed reasonable if made in accordance with current mining, industrial engineering, and accounting practices would provide guidance and help reduce the administrative burden on all parties.

SMCRA facilitates such a definition. It provides that all persons who engage in surface coal mining must obtain a permit prior to commencement of mining operations. Permit applications must contain a reclamation plan which, among other things, outlines the method to be used as well as the costs involved in reclaiming land altered by coal mining activities. The estimated expenses are in current dollars and are calculated according to sound engineering practices. A permit is not granted until the Federal Office of Surface Mining [OSM] or the State regulatory authority approves the reclamation plan. A performance bond, sufficient to insure the completion of the reclamation plan should the operator not fulfill its statutory duty, must be secured by the coal operator to obtain a permit.

This reclamation plan, required to be submitted by SMCRA, provides a firm and reliable basis for estimating future reclamation costs. The estimated costs in the reclamation plan are not guesstimates. They are calculated on the basis of accepted engineering and accounting principles. As such, they are known at the time the liability attaches I.E., when the land is disturbed. Any motivation on the part of coal operators to take excessive reclamation cost deductions on the basis of inflated estimates in the reclamation plan is tempered by the considerable cost of acquiring a performance bond for the projected reclamation expense and the surety industry's general requirement of pledging collateral equal to the amount of the bond.

Mr. Chairman, guidance in applying the term reasonable would serve to avoid needless litigation and promote administrative certainty. MARC encourages the subcommittee to recommend such a definition.

An additional point I wish to highlight, Mr. Chairman, is that Representative Filppo's bill, H.R. 3442, recognizes the need to provide the same tax treatment for cash basis taxpayers who may choose to set up a reserve account to meet future reclamation liability. This is an important issue for many smaller coal operators and, as a matter of equity, should be provided for under applicable law.

Mr. Chairman. I wish to underscore two points.

First, the pending legislation does not create new law; it codifies existing law. It will provide significant relief from unnecessary legal and ancillary expenses for surface coal operators, the IRS, and the courts. It will not open a door for other taxpayers to claim similar deductions, since, in the case of coal mine operators, there is a specific fixed liability mandated under Federal and State law which is subject to accurate calculations using accepted engineering principles at the time the land is disturbed.

Second, enactment of this legislation will relieve a significant burden on a substantial number of coal operators who are struggling to survive under current economic conditions and help to assure that the United States will continue to have a highly competitive and efficient coal industry.

MARC encourges the subcommittee, Mr. Chairman, to support the pending legislation and to encourage your colleagues on the Ways and Means Committee to favorably consider it in the near future.

STATEMENT OF DENNIS P. BEDELL, CHAIRMAN, TAX COMMITTEE, ON BEHALF OF THE AMERICAN MINING CONGRESS

Mr. BEDELL. I am Dennis Bedell, and I appear before you on behalf of the American Mining Congress.

Since my colleagues commented on the specifics of the situation affecting the mining industry, allow me to comment briefly on two general matters that deserve further clarification.

In the Treasury's testimony, the implication is that a problem has arisen only in the last 2 or 3 years because it was in that time that the Tax Court decided the *Ohio River Collieries* case.

The record should clearly show that it was in 1951 when the Fourth Circuit Court of Appeals first held to the same effect as the Tax Court with respect to the timing of accrual of mining reclamation expenses, and it was in 1959 that the Third Circuit Court of Appeals held to that effect. So, this has been a longstanding, con-

sistent position of the courts with respect to the treatment of mining reclamation expenses.

Second, the Treasury's proposal for deferring deduction of an expense that is properly accruable now, because the time of the payment is not until a future point, is stated by the Treasury Department to be a fair proposal. We respectfully submit it is not fair.

The determination of the timing and amount of expenses is not something we do in the abstract because it has independent abstract significance. We do it because it is an element in the determination of taxable income, the bottom line which taxes are imposed.

There are a number of facets of the accounting system that are used to determine taxable income where present value may be relevant. Treasury, however, has focused on one element, the deduction for current expenses.

Income is another element that goes into the determination of taxable income and there can be a difference in the time when income must be accrued and the time when it is received.

The same thing is true of capital expenditures. The outlay occurs currently but our system does not allow the accrual, the deduction until a future year, so the amount of the deduction in fact is understated.

Treasury has picked one piece of the income determination equation out and said, "We have a problem. We should put a present value system on that piece."

It has ignored the other pieces that go into the determination of taxable income and that ought to also be taken into account if we are going to go to a present value-type mechanism in our income tax system.

Thank you for your time.

[The prepared statement follows:]

STATEMENT OF DENNIS P. BEDELL, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS

Mr. Chairman and members of the subcommittee, my name is Dennis P. Bedell. I am Chairman of the Tax Committee of the American Mining Congress and a member of the Washington, D.C. law firm of Miller & Chevalier, Chartered.

I am appearing before you today on behalf of the American Mining Congress. We appreciate this opportunity to testify with respect to the accounting methods prescribed by the federal income tax system and the relevance of the time value of money in applying those methods.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

In its revenue proposals the Administration chose to address the subject matter of this hearing under the heading of "Accounting Abuses-Premature Accruals." In this regard, the Treasury Department argued that present law overstates the true cost of an expense because it fails to take into account the time value of money. It further argued that the failure of current law to defer a deduction for a future expense has become the cornerstone for a number of tax shelters. In addition it stated that present law results in "extreme distortions." To cure this "extreme distortion," the Treasury then proposed that accrual basis taxpayers in effect be placed on the cash method of accounting—but only with respect to current expenses, not with respect to other facets of the determination of taxable income where the concept of time value of money is equally relevant. Thus, the Treasury's arguments, suggestions and proposals are most noteworthy for what they don't say and what they don't explain.

They don't say why they refer to time value of money when in fact they are talking not only about use of money but also about inflation. This is evident from the fact that the Treasury in illustrating its proposal assumes an 8 percent after-tax rate of return as the prope. measure of "time value of money." Since an 8 percent after-tax return in the case of a corporate taxpayer constitutes a 17.4 percent before-tax return, it is clear that Treasury in reality is asserting that not only must use of money be reflected in the tax system but also that inflation must be reflected.

Most importantly and significantly, Treasury in making its proposal does not explain why in thinking about time value of money it focuses on only one facet of the determination of taxable income; namely, an accrual basis taxpayer's deduction for current expenses. Treasury does not explain why it ignores the income side of the equation and why it ignores the capital expenditure side of the equation.

Treasury does not explain why, if allowing an accrual today for an expense paid tomorrow constitutes an "extreme distortion," the similar requirement of present law that income be accrued today even though it will not be received until tomorrow does not in like manner constitute an "extreme distortion" that must be remedied. Numerous instances exist in which income must be accrued today even though it will not be received until some point in the future such as, for example, in the case of services and payments under various types of license and know-how agreements.

The Treasury also does not explain why it fails to focus on an extremely important aspect of tax accounting with respect to which time value of money and inflation are most important, namely, the treatment of expenditures for plant, equipment, buildings and other capital items. If the absence in our tax accounting rules of provisions for reflecting the time value of money and inflation constitutes an extreme distortion, this is nowhere more clearly true than in the case of expenditures for capital items: The cash outlay for the item occurs today but the deduction is not allowed until future years. In other words, capital cost recovery allowances are based n historical costs, which reflect neither use of money nor inflation, rather than on future replacement costs which would take time value of money and inflation into account.

Moreover, the Treasury does not explain why, if the present accrual accounting rules provided for income tax determination purposes result in "extreme distortions," those rules are nevertheless used by the entire accounting profession for purposes of the preparation of financial reports to shareholders and to all governmental agencies and for other purposes and why the application of those rules is considered by every other federal government agency, including the Securities and Exchange Commission, to result in a clear and proper reflection of income.

The Treasury also does not explain why, if the present accounting rules are a "cornerstone for a number of tax shelters" and cause "extreme distortions," the Revenue Service itself has administratively permitted a class of taxpayers to currently deduct future expenses, which may not even be properly deductible under the accrual method of accounting. In Revenue Procedures 75-25 and 78-25 the Service reiterated the position it has followed since 1933 of allowing real estate developers who are developing a subdivision to estimate the future costs of the future improvements they are contractually obligated to make and to then include those estimated future expenses in the basis of lots they have sold, for purposes of determining taxable gain. Thus, the Service allows these developers to deduct those estimated future expenses from the gain they must report on the sale of the lots. The Revenue Service allows this treatment even though the estimated future expenses have not been paid and even though they may not be properly accruable.

If the Treasury in fact is concerned, as it says it is, about tax shelter partnerships incurring research and experimental expenditures to be paid for in the future, then corrective measures should focus on tax shelter partnerships. The answer to that tax shelter problem should be one directed to the problem, not the wholesale repeal of a portion of the accrual method of accounting. That, nevertheless, is what the Treasury is proposing. In effect it is suggesting that accrual basis taxpayers be placed on the cash method of accounting insofar as current expenses are concerned. Treasury, however, wold retain the accrual method—and thus ignore the time value of money and inflation—for reporting income and for deducting expenditures for plant, equipment, buildings and other capital goods. This hybrid method of accounting that would result from the Treasury's proposal has no basis in sound accounting theory. Moreover, it also surely will result in substantial distortions in the determination of taxable income, because it will introduce the effect of time value of money and inflation with respect to one facet of the computation, one type of deduction, but not with respect to those other facets of the computation where the effect is equally relevant, the taxpayer's income and other types of deductions.

The time and effort of the Treasury Department would be much better expended in governing the Internal Revenue Service and requiring the Revenue Service to comply with the tax laws so that needless controversies with taxpayers would be minimized. The Revenue Service's failure to follow the law is well illustrated by the situation which exists with respect to mine reclamation expenses.

The courts have concluded time and again that mine reclamation expenses are properly accruable when the mine operator first disturbs the land on which the mining operation is conducted. It is at this point that liability to restore the land arises under the mandates of federal and state law and, accordingly, it is at this point that the estimated expenses of the restoration activity are properly deducted for federal tax purposes.

Notwithstanding the position of the courts on this matter, the Revenue Service continues to challenge taxpayers' accrual of mine reclamation expenses, thus generating needless cointroversies, contrary to the sound and efficient administration of the tax laws.

In essence, the problem which arises results from the fact that mine operators are required by federal and state law to reclaim surface land which their mining operations have disturbed. Indeed, under the federal surface mining laws, a mine operator prior to beginning its mining operation must formulate and have approved a comprehensive mining reclamation plan, as well as post a performance bond or other evidence of financial worthiness to assure that the reclamation activities contemplated by the mine operator's plan in fact will be performed by the mine operator.

Thus, when a mining operation begins, it is clear that the mine oprator will be liable for the reclamation and restoration of the disturbed land. Since the reclamation activity will not take place until a point in the future, the actual expenditures for the activity will not be made until that future time. Under the generally applicable principles of the accrual method of accounting prescribed by the Internal Revenue Code, however, a future expense is properly accruable, and hence deductible, in the currrent year if the taxpayer's liability for that expense is presently established and the amount of the expense can be estimated with reasonable accuracy. In applying these general principles the courts have found them satisfied in a number of instances with respect to mine reclamation expenses. Indeed, the most recent case, the 1981 Tax Court case of *Ohio River Collieries Company* clearly found that a reclamation requirement imposed by state law satisfied the requirements for current deductibility of the estimated future mine reclamation expenses.

In view of the manner in which the courts have construed the accrual deductibility requirements of present law with respect to the treatment of mine reclamation expenses, it does not make any sense from the standpoint of sound and efficient tax administration or tax equity and fairness for this to continue to be an area of dispute between taxpayers and the Internal Revenue Service. It must be remembered that although the *Ohio River Collieries Company* case is of recent vintage, similar judicial authority for the current deductibility of future mine reclamation expenses has existed for many years. Moreover, the existence of the mine operator's liability for the expenses is clear since that liability is established by law and is reinforced by the performance bonds or evidence of financial capability which are required to be posted or demonstrated. In addition, the mining and mining engineering industries have had substantial experience with mine reclamation activities and, accordingly, have the ability to formulate reasonable estimates of the cost of future mine reclamation expenses.

In summary, sound and rational accounting principles and theory provide that income is appropriately and clearly reflected under the accrual method of accounting without taking the time value of money into account. Among other things, this is evidenced by the fact that no federal agency with which financial reports must be filed or which has supervisory responsibility over financial reports requires that time value of money be taken into account in determining net income. Notwithstanding this, if it is concluded that it is necessary to revise the accounting rules found in the Internal Revenue Code, then certainly any revision should be a rational, consistent one, not an irrational hybrid one such as that proposed by the Treasury. A rational revision of the accrual method of accounting cannot relate to only one facet of the determination where time value of money is relevant but rather must be equally applicable for all relevant aspects of the accounting determination of taxable income. In other words if taxpayers in effect are to be required to use the cash method of accounting for current expenses, as the Treasury is suggesting, then the cash method also must be used for reflecting income and for accounting for capital cost expenditures. Otherwise, the distortions which will result in determining income truly will be "extreme distortions."

The American Mining Congress respectfully submits that the Treasury's revenue proposal for "premature accruals" is not a minor technical change but rather is a fundamental change in a portion, and only a portion, of the tax accounting rules. It is a fundamental change which fails to embody balance or consistency. It is a fundamental change which departs from and indeed contradicts sound accounting principles and theory. It should be rejected by Congress. If after full deliberation it is felt that reflection of time value of money and inflation in the tax system is necessary, then the approach to accomplishing that task should be a balanced and even-handed one that provides for equally applicable adjustments in every facet of the determination of taxable income with respect to which time value and inflation are relevant—i.e., whenever there is a difference in the timing of the accrual event and the timing of the cash outlay or receipt.

Mr. DUNCAN. Thank you, Mr. Chairman. I have no particular questions.

I would like to welcome our former colleague, Mr. Don Bailey.

Chairman RANGEL. Mr. Thomas.

Mr. THOMAS. No questions.

Chairman RANGEL. I wish to welcome Don Bailey and the entire panel. We will be working very, very closely with Treasury.

The next panel that has been invited by the subcommittee to share their views with us: First, former chairman, of the American Bar Association, the Section of Taxation, an old friend of the committee, Bernard Aidinoff; and also from the ABA, the chairman-elect, James Lewis; and Victor Keen, member of the New York Bar Association; and Emil Sunley, director of tax analysis, at the firm of Deloitte, Huskins & Sells.

Mr. Aidinoff.

STATEMENT OF M. BERNARD AIDINOFF, SULLIVAN & CROMWELL, FORMER CHAIRMAN, AMERICAN BAR ASSOCIATION, SECTION OF TAXATION

Mr. AIDINOFF. It is a pleasure to be here again.

Although I am listed on the manifest as former chairman of the ABA Tax Section, I am not speaking on behalf of the Tax Section. I do not know what their views are on this subject. I am expressing my own personal views as a private lawyer and one who has had some experience in this area.

In addressing the problem of premature accrual, it might be helpful to look at what existing law is.

Mr. Pearlman spoke about the all events test.

My experience with the application of the all events test is that the Internal Revenue Service has consistently taken the last part of the test; that is, determining the amount of the liabiity with reasonable accuracy as a device for arguing that there should be no deduction at all.

The courts have consistently rejected that approach, particularly in the strip mining cases; you don't just have to go back to the recent *Ohio Collieries* case, you can go back 10 or 15 years earlier, and you will find that the courts have said that as long as there is a reasonable estimate, that represents the degree of accuracy that is necessary.

None of us would tell you that we can ascertain with great precision the amount of restoration expenses that are actually going to be incurred if those restoration expenses take place 10, 15, 20 years from now, but in the conduct of our businesses, it is necessary to

make a good faith estimate of those expenses, sometimes for rate-making purposes, certainly for financial accounting purposes. If I have any experience in the area at all, it is that most of the estimates have turned out to be too low rather than high. In most instances a taxpayer is underaccruing his liability rather than over-accruing.

The most important question that you have to consider is whether the taxpayer is getting a windfall by having a deduction allowed before there is so called economic performance.

Are taxpayers really getting a windfall if that $100 million of reclamation expenses is allowed over, let us say, the 20-year period before the expenditure is going to be made?

In many ways, this is just the flipside of the Internal Revenue Service, the Treasury and the Congress saying that if I purchase an asset which has a 5- or 10-year life, whatever the asset recovery period is, I do not get a deduction in year one for the full cost of the asset.

What the Treasury's proposal in effect does with respect to this type of liability which accrues over time, is say, let us go on a cash-flow basis.

Well, accrual accounting is not a cashflow basis of accounting. We had a case in the second circuit which amused and frightened many of us. The case involved a contract for 10 years of dancing lessons with payments over 10 years. The IRS required that the full amount of that income be accrued in year one, even though the dancing lessons were not going to be paid for except over the 10-year period.

The problem of course is that a straight line deduction for, let's say, $100 million liability to be satisfied in the 20th year really defies the normal rules of how the value of money accrues.

An appropriate analysis is to consider what the present value is. One could require that that present value of the liability be put into a fund and a deduction allowed in year 1. But it is not enough to say that one should just get a deduction for the present value in year one. One also has to say that the earnings on that fund either have to be taken into income and then treated as redeposited in the fund with a deduction for that amount, or the earnings have to be treated as tax-exempt.

There is a table in my testimony which in effect shows that if you did this on a 15-year liability, the footnote on page 10, you would have a fairly large deduction in year one. Whether you put such amount in a fund, or just allow the present value of the liability as a deduction without a separate fund, the problem of a huge deduction at the front end could essentially be handled if you wanted to, by in effect amortizing the present value and adding different interest deductions, as you went along.

Alternatively, you could break down the future liability into a series of present values with different discounts being attached to each.

For example, if I were talking about 15 years, one-fifteenth would be for 15 years in year one, one-fourteenth would be for 14 years in year two, and so forth.

The important thing is that if one can come up with a system which in effect gives an increasing amount of deductions as time

goes on—smaller deductions in the earlier years with higher deductions in the later years—one takes away most of the windfall, and one does it in a way which is consistent with good accounting principles. In effect, the liability side of the balance sheet for tax purposes is treated the same way as the asset side.

Now, we all agree that the present carryback situation today just does not make sense with respect to long-term liability. It just does not handle the problem of giving the deduction at a time when there may not be any income.

Furthermore, if you have a carryback for 10 years, you are recovering, in inflated dollars, deductions that were incurred at a time when the dollar was worth much more.

I do not think that the problem of premature accruals is as great as the Treasury suggests. By discounting properly, you can take out some of the windfall when you talk about real long-term liabilities. When you talk about 5-year liabilities, I don't think it is worth the complexity. If you are concerned about making sure the actual cash is there, maybe you have to have a set-aside fund.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF M. BERNARD AIDINOFF, SULLIVAN & CROMWELL, NEW YORK, N.Y.

Congressman Rangel, members of the Subcommittee on Oversight, thank you for permitting me to testify this morning on the subject of "premature" accruals. My name is M. Bernard Aidinoff. I am a partner in the law firm of Sullivan & Cromwell in New York City. I am appearing in my private capacity as a lawyer who has dealt with the issue of such accruals.[1] The views that I express will be my own personal views.

In addressing the problem of "premature" accruals, I will confine my remarks to the proper tax treatment of a single long-term liability arising out of an obligation that is not to be performed for many years. Such a long-term liability can arise from an obligation to restore a strip mining site, to decommission a nuclear powerplant or to dismantle and remove an offshore drilling rig, an obligation which is fixed but, in some cases, may not be performed for as many as forty years.

Under present law, as interpreted by the courts, accrual-method taxpayers are entitled to deduct the amount of a liability arising out of an obligation to be performed in the future at the time when all the events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy. The rule, known as the "all events" test, is based on one of the fundamental principles of accrual accounting, the principle of matching in the same period revenues and the costs of earning such revenues, although the requirement that the liability be determined with reasonable accuracy can in many cases distort the application of the matching principle. In practice the Internal Revenue Service has consistently opposed taxpayers who seek to accrue the costs of a long-term liability in the years before the obligation is actually performed, usually on the grounds that the cost of performance cannot be presently determined with "reasonable accuracy." For example, the Service has denied taxpayers a deduction for the eventual cost of restoring strip mining sites, an obligation often imposed on the taxpayer by state law. The courts, on the other hand, have allowed accruals in the strip mining cases on the basis that accrual accounting requires the costs associated with strip mining to be matched with the revenues therefrom, and that the cost of the eventual restoration liability, although not capable of being precisely determined, can nevertheless be measured with "reasonable accuracy."

The Administration proposes to amend the "all events" test to provide that no deduction would be allowed in respect of future liabilities until "economic performance" occurs, that is, until the time the taxpayer actually performs the required services or satisfies the liability. In the case of a taxpayer who does not have substantial income in that year, a part of the deduction for the cost of the liability will

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[1] See Aidinoff & Lopata, Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising from Obligations to be Performed in the Future, 33 Tax Lawyer 789 (1980).

be lost except to the extent that it can be carried backward or forward to offset taxable income for other years. The Administration proposes to solve this problem by amending the loss carryback rules to allow a loss arising from the performance of certain obligations to be carried back ten years, and in the case of decommissioning a nuclear powerplant, to the year in which the obligation to decommission the plant first arose.[2] While a liberalization of the loss carryback rules is desirable if the Administration's proposal with respect to the year of deduction is adopted, taken as a whole the Administration's proposal will deprive taxpayers of deductions that they are legitimately entitled to claim under an accrual method of accounting. A simple example will demonstrate the application of the "all events" test under present law, the misunderstanding of accrual accounting inherent in the Administration's proposal, and, I suggest, the appropriate economic framework for analyzing the problem of accruals for long-term liabilities.

Assume that a taxpayer on the accrual-method obtains a lease which permits it to conduct strip-mining activities in a state which requires strip mine operators to restore the mine site to its natural environmental condition after mining activities cease. Assume further that the lease term is fifteen years commencing January 1, 1985, that strip mining activities will cease at the termination of the lease and that the taxpayer, on the basis of both its own prior reclamation experience and the estimates of outside contractors, determines that it will cost $100 million at current price levels to restore the mine site when the lease terminates in 2000.

Under present law, the taxpayer in this example will be entitled to deduct the cost of its restoration obligation when the events that determine the fact of this liability have occurred and the amount of the liability can be determined with reasonable accuracy. The events that determine the fact of the taxpayer's liability will be the strip mining activities themselves, so that a portion of the total restoration obligation will accrue each year that the taxpayer conducts strip mining activities. The portion of the total liability that accrues each year could be determined with reasonable accuracy in one of two ways. One alternative would be to estimate the total mineral production of the strip mine for the period of its operation and apportion the costs of restoring the mine site on a units of production basis. A second alternative would be to amortize the $100 million ratably over the lease term, on the assumptions that strip mining will occur in each year of the lease term and that approximately equal amounts of minerals will be produced in each year. In any event, $100 million of deductions will be available to offset taxable income before the taxpayer undertakes the restoration. Assuming the taxpayer has sufficient taxable income and that the income is taxed at a fifty percent rate, $50 million of additional cash flow will be available over the lease term. Arguably, the taxpayer in this event reaps a windfall attributable to its increased liquidity and the additional earnings generated by the cash flow. If, on the other hand, the conditions for accrual under present law are not considered to be met until the mine site is actually reclaimed, no deduction would be permitted until restoration occurred. In this event, if one assumes that the corporation operating the mine carries on no other activity and is not part of an affiliated group that has other income and files consolidated returns, the deduction generated by the mine site restoration obligation will be usable only to the extent of the income generated in the last year of mining operations (assuming that restoration commences in that year) and the applicable carryback period. In some instances the ten-year carryback proposed by the Treasury may not provide the taxpayer with sufficient income to offset the expenditure, particularly in a period of inflation.

I am dissatisfied with the present state of the law, particularly with the way in which the "all events" test is applied by the Internal Revenue Service. The Internal Revenue Services has interpreted the "reasonable accuracy" requirement too narrowly, with the result that taxpayers who are unable to determine the exact cost of performing a future obligation are denied any deduction, even for an uncontested minimum cost. My experience has been that not only can the cost of performing future obligations often be determined with reasonable accuracy but that, where an estimate is later proved to be inaccurate, it is usually because the actual cost significantly exceeds the original estimate.

Although the Administration's proposal is a step in the right direction because it would, in many cases, eliminate the feast-or-famine results caused by the current rules and apply a more uniform rule to similarly situated taxpayers, the proposal is nevertheless seriously defective. Quite simply, the effect of the proposal is to abandon the concept of accrual accounting in favor of a cash-based method. While the

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[2] Staff of the Joint Committee on Taxation, Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions, p. 70 (Feb. 17, 1984).

application of cash-method principles is advantageous to the Treasury Department in this instance, taxpayers will be quick to note that, as a logical corollary, cash-method principles should apply to the asset-side of the balance sheet as well. If cash-method principles were applied to capital investments, taxpayers would be entitled to deduct the full cost of an asset in the year of acquisition rather than, as under present law, recouping the cost over the asset's recovery period. It also should be noted that the Internal Revenue Service has consistently argued for the current taxation of accrued income even though the income may not be received in cash until a later year (e.g., contracts providing for ten years of dancing lessons). In addition, the Service has fought cash-basis taxpayers who have attempted to deduct prepaid expenses where the cost are properly related to a late year. I do not mean to say that the Service's current positions with respect to prepaid income and expenses are incorrect, but I do think they are inconsistent with the position embodied in the Administration's proposal with respect to accrued liabilities.

Perhaps we should be willing to tolerate deviations from an ideal method of accrual accounting if it were proved that the principle of matching costs to related revenues could not adequately deal with the problem of "premature" accruals. But we do not have to make this sacrifice. On the contrary, the proper economic frame work for analyzing the problem of "premature" accruals is a framework that adheres to the matching principle even more closely than does current law, namely, the method of economic accrual or constant interest. Such an approach recognizes that the performance of any future obligations is, in substance, like the payment at maturity of a zero coupon bond. Splitting the liability into present value and discount portions recognizes that some portion of the liability would, if paid currently, have the same economic cost to the taxpayer as the entire liability paid in fifteen years. Such a division also recognizes that the cost of the liability that should be currently deducted is the present value of the liability only, and that the difference between the present value and the full amount of the liability as presently determined should be viewed as a payment by the taxpayer for the benefits occasioned by the delay in its having to incur the restoration expenditure and should be amortized, based on increases in present values, over the entire period in which such expenditure is delayed.

The application of the constant interest method would, in my strip mining example, distinguish between the present value component of the restoration obligation and the portion that resembles original issue discount. Assuming a long-term interest rate of ten percent, the present value of $100 million in fifteen years would be approximately $24 million. This present value component of $24 million could be treated a number of ways. It might be allowed in its entirety as a deduction in the year strip mining begins, or it might be allowed as a deduction in that year only if the taxpayer invested it in a special reserve (composed, say, of Treasury notes) that would equal $100 million after fifteen years. One advantage of setting aside the present value component of the future obligation in a reserve is that the taxpayer would then be denied the windfall due to the increased liquidity and earnings he would otherwise receive on the cash flow created by the deduction. Another advantage is that, like a sinking fund, a reserve assures the obligee that the funds to pay for the performance of the liability will be there when needed. Alternatively, the present-value portion of the liability could be treated as a capitalizable expense to be amortized ratably over the lease term of fifteen years, recognizing that the cost of reclaiming the mine site is, in fact, a cost of the lease. Whether the present value component of the liability should be deducted currently or amortized ratably may depend on the nature of the future obligation. For example, where a liability is fixed from the beginning, as where a nuclear power plant is built that will one day be decommissioned or a drilling rig is erected that will eventually be dismantled, the present value portion of the liability should arguably be deducted in the year the liability becomes fixed. On the other hand, where the liability itself accrues year by year, as in my strip mining example, it would seem more appropriate to spread the present value portion of the liability over the period during which the obligation is deferred.

However the present value portion of the restoration obligation is treated, the remainder corresponds to the original issue discount portion of a discount note and, as such, should be amortized over the lease term based on the increments in present value of a $100 million note payable in fifteen years and discounted at a pre-tax rate of ten percent. This would result in relatively small deductions in the early years of the lease with larger deductions following in the later years.[3] I might note

[3] If the present value portion of the liability is deducted in full in the first year, the amount of the taxpayer's deductions for each year would be as follows: Year 1, 26,333,125; year 2,

Continued

that if the taxpayer were required to fund its future liability through a special reserve, it would make no difference whether the earnings of the reserve were taxable or tax-free, because if they were taxed the taxpayer would be entitled to a corresponding deduction for the addition to the reserve. Another way to put it would be that if earnings on the present value portion of the liability were tax-free, the total deduction permitted the taxpayer with respect to the future liability would be limited to the present value of the liability.

I recognize that a number of practical considerations would have to be taken into account if a discounting requirement were to be instituted. First, a method of ascertaining the appropriate discount rate would be required. This is not hard to do for a discount note, indeed, it can be ascertained by a simple (I am told) mathematical calculation. While arguably the ideal discount rate would represent the taxpayer's internal rate of return, this rate will differ among taxpayers and is subject to their manipulation; therefore, I suggest that the applicable discount rate reflect current market interest rates. Second, taxpayers would be required to make an estimate, no matter how difficult it was to do so, as to the time of performance in order for the appropriate discount period and the appropriate discount rate to be determined. Neither of these concerns, however, should prevent the adoption of what would be a method of treating liabilities that both matched deductions with the period to which they properly related and at the same time more clearly accounted for the benefits derived by taxpayers from obtaining deductions in advance of performance.

There is a further problem. I have assumed that the restoration liability at issue in the strip mining example can be determined with reasonable accuracy to be $100 million in 1985 dollars. Because of inflation, however, it is unlikely that $100 million in year 2000 dollars would satisfy the taxpayer's obligation. On the contrary, the liability at that time could well have increased by several times its current-dollar estimate. Inflation can be a significant factor where obligations are to be performed far in the future, and ignoring this will not serve the interests of the party to whom the obligation is owed. The extension of the loss carryback period does not adequately mitigate this problem, because refunds received by a taxpayer who carries back a loss will be in inflated dollars, thus denying him the full benefit of a deduction that is properly related to an earlier period. The problem of inflation could be handled by allowing increases in the present value of an accrued liability to be deducted in the taxable year in which the inflationary increase occurs, and adjusting the discount portion during the remaining term.

In summary, the present rules that govern the deductibility of expenses by accrual-method taxpayers suffer from a basic fault: they were drafted with short-term liabilities in mind. They do not adequately treat long-term liabilities arising from obligations to be performed in the future, liabilities whose exact amounts can only be estimated, and may consequently be subject to change, well before the cost of performance has finally been determined. The Internal Revenue Service has exploited this fault, unjustifiably, I think, to deny many taxpayers deductions for accrued liabilities. The Administration's proposal, although well-intended, suffers from a basic misunderstanding of the principles of accrual accounting, a misunderstanding that blurs the distinction between the methods of cash and accrual accounting to the disadvantage of the taxpayer. This distinction is one of the fundamental features of our tax law, and we should not undermine it merely to counter in an expedient fashion a perceived abuse. The approach to long-term liabilities that I have advanced, an approach based on the same method of economic accrual that has been adopted or proposed for other areas of the tax law in which the time-value of money is a significant factor, is more faithful to the concept of accrual accounting than the Administration's proposal. As a consequence it would achieve a greater degree of

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2,633,313; year 3, 2,896,643; year 4, 3,186,309; year 5, 3,504,940; year 6, 3,855,432; year 7, 4,240,976; year 8, 4,665,074; year 9, 5,131,581; year 10, 5,644,739; year 11, 6,209,214; year 12, 6,830,134; year 13, 7,513,148; year 14, 8,264,463; and year 15, 9,090,909.

If the present value portion of the liability is amortized ratably over the lease term ($1,555,542 each year) the amount of the taxpayer's deduction for Year 1 would be only $3,949,462 ($1,555,542 plus the interest for Year 1 as computed above, or $2,393,920) and the deduction for Year 15 would be $10,646,451 ($1,555,542 plus the interest for Year 15, $9,090,909).

There are other possibilities. For example, the total liability of $100 million could be viewed as 15 separate liabilities equal in amount after 15 years. The first portion of the liability would accrue interest for 15 years, the second for 15 years, etc. Although the discount rate would remain the same, the portions of the liability on which interest accrued would increase year by year; consequently, the disparity between the amount of deductions in years 1 and 15 would be greater than in the method described immediately above. In a situation where the liability accrues over time, as in the strip mining example, this method would best match the cost of the liability to the taxpayer's revenues over the period of deferral.

fairness, both to taxpayers and the Department of the Treasury. The present value-discounting approach will mitigate the "windfall" that would otherwise accrue to taxpayers from deductions for amounts not yet actually expended. And not least of all, it would do more to assure that the future obligation, which is often an obligation owed to the public at large, is in fact performed. While further refinements, such as whether the taxpayer should be required to set aside amounts in the manner of a sinking fund, must be made, I hope the suggestions I have put forward today provide a helpful start toward achieving a more equitable, and economically realistic, treatment of the long-term unperformed obligations of accrual-method taxpayers.

Chairman RANGEL. Mr. Lewis.

STATEMENT OF JAMES B. LEWIS, PAUL, WEISS, WHARTON & GARRISON, AND CHAIRMAN-ELECT, AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, ACCOMPANIED BY JAMES K. JEANBLANC, GINSBURG, FELDMAN & BRESS

Mr. LEWIS. I am James B. Lewis of New York City, chairman-elect of the American Bar Association, Section of Taxation.

With me on my right is James Jeanblanc, chairman of our recently appointed task force on the issue of the time value of money.

Neither the section nor the American Bar Association has had sufficient time to develop a position on this subject, and, therefore, I speak not as a spokesman for the section or the association, but in my individual capacity.

I have basically two requests that I would like to make of the subcommittee, and through you to the full committee.

The first is that this legislation not be drafted overnight.

Experience has shown that good legislation can be achieved only by first drafting it, and then permitting professional groups such as ours and others to study it, find out the bugs in it, get the bugs out and then enact it.

Therefore, it would be premature for me to try to deal with the intricacies of this subject now.

I suspect that when you sit down to draft that you will find a lot of difficulty in defining the term "economic performance." I don't know whether it is the time at which the liability becomes fixed and determined or whether it is the later date on which payment is made, and which is the right one, but you are going to have a lot of difficulty and this should not be done hastily.

The second request I have is that when you examine the subject, you should examine both sides of it.

The Treasury has addressed one side only, and that is the case of accrual of expenses that have not yet been paid.

The Treasury has not discussed with you the question of accrual of income that has not yet been received, and logically, it seems to me, the two subjects should be treated alike. If they are treated alike, I do not know whether this provision is a revenue loser or a revenue gainer.

Now, when you do go to work on the subject, I hope that the section of taxation will have its thinking in order, and we would much appreciate the opportunity to appear here again and to discuss proposals that have been fleshed out, so that we can help with the fine tuning.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES B. LEWIS, PAUL, WEISS, WHARTON & GARRISON, NEW YORK, N.Y.

Mr. Chairman and members of the Subcommittee, I am James B. Lewis of New York City, Chairman-elect of the American Bar Association Section of Taxation. Neither the Association nor the Section has had sufficient notice to formulate policy on the subject matter of these hearings. Therefore, I appear in my individual capacity and not as a representative of either the Association or the Section.

The Administration's "time value of money" proposals deserve careful study. They have been designed to deal with perceived abuses in the tax accounting area, involving mismatching of income and expense. In particular, the Administration has proposals to revise the method of identifying the portion of deferred payments that represent interest, to prevent what is perceived as the premature deduction of expenses paid before the taxable period to which they are properly allocable, and to prevent what is perceived as the premature tax accrual of major expenses that need not be paid until years later.

The Section of Taxation has recently established a special Task Force on the Time Value of Money. That Task Force has been charged with the responsibility of evaluating the problems in this area and with assisting the Section in developing recommendations for this and other Congressional tax bodies. We expect to share the results of our work with this and other such bodies as they consider the Administration's proposals.

It would be useful to have more specific data on the areas of abuse and the extent of their utilization. It is easy to see that there are perceived abuses, but more information might lead to better targeted reforms.

We would also welcome the opportunity to testify on these reform proposals after they have been more fully developed, preferably after they have been translated into proposed statutory language. At that time, we and other professional groups would be better able to consider the competing problems of tax equity and complexity and to make alternative proposals and suggestions for fine tuning.

One concern noted by several private practitioners is that the proposals are not even-handed. They are all designed to increase tax revenues by preventing taxpayers from enjoying the time value of deferred tax payments. There are other situations in which the present tax accounting rules work unfairly against the taxpayer. If the Congress legislates regarding premature expense payments and accruals, it should also deal appropriately with premature income receipts and accruals.

Practitioners have also noted that the Administration's proposal regarding deferred payments is conceptually inconsistent with its proposals regarding what it regards as premature expense deductions. In the deferred payment area timing of the receipt is respected, but in the expense area timing of the payment on accrual is challenged. More study might produce a more consistent set of solutions.

The perceived tax abuses that are the target of the proposals may merit the proposed solutions, but before Congress takes action here, it should thoroughly consider all of the ramifications of each proposed change. Quick changes in this area could result in unintended consequences. For example, we now see how section 483, which was added to the Code to correct a tax abuse, is now the source of one of the present tax abuses. In particular, each proposal should be carefully tested from the standpoints of complexity, ease of compliance, and ease of administrability.

The Section of Taxation will be happy to cooperate in that activity.

Chairman RANGEL. Mr. Keen.

STATEMENT OF VICTOR F. KEEN, WHITMAN & RANSOM, MEMBER, COMMITTEE ON TAXATION, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Mr. KEEN. Thank you, Mr. Chairman.

My name is Victor Keen, and I am a New York City lawyer.

I am appearing today on behalf of the Committee on Taxation of the Association of the Bar of the City of New York.

Last June, the committee, in part at the request of Treasury, prepared a report that, generally speaking, covered the very subject of this hearing. As a matter of fact, Buck Chapoton and Ron Pearlman themselves received a copy of our report before most of the members of the committee.

The report having been issued last June, the committee had no opportunity to consider the administration's proposal. The report basically consisted of a consideration of what the current law was, and whether there were abuses. It did not propose alternatives. I would like to limit my comments to some aspects of current law without repeating some of the things that have been said this morning.

Four the subjects that were covered by our report were the subject of this morning's earlier comments: structured settlements, the unemployment benefit cases, workers' compensation cases, and the strip mining cases.

I would like to take these four areas and make some distinctions in these areas under current law that may not have come out this morning and relate those distinctions to my understanding of the administration's proposal.

As Jim Lewis points out, without having bill language, it is a little difficult to grasp the concept in the administration proposal of economic performance.

In my testimony, and in the city bar report that I have made a part of my testimony, we dealt first with structured settlements. I will take that example to make a point about the administration's proposal.

In a typical structured settlement, you would have an obligation by a taxpayer to make a payment to a known recipient at a discrete point in time of an absolutely determinable amount. Our committee determined that there was absolutely no way to argue that all the events had not taken place. The concept of economic performance, unless you say that performance is actually writing out the check, has no application.

It is my understanding that the concept of economic performance would, in the administration's bill, cover this very case, at which point it becomes in my mind tantamount to the cash basis of accounting.

If economic performance is to cover that type of case where there really are not uncertainties as to amount, as to recipient or as to time, the term "economic performance" is a bit of a euphemism.

Let me carry this point forward by discussing that concept in the context of the other types of cases that we have considered.

A fair argument can be made that in the strip mining cases, there is some economic performance to be performed; intellectually perhaps that fact should be a bar to a current accrual. As has been pointed out already, and I had it recalled when I reread Bernie's article this morning, the last case on which the service could rely on the strip mining context was decided in 1944. Every case after that has supported the accrual.

In the other areas, you have an intellectual argument that all of the events have not taken place, either because some performance is required or the amount cannot be determined with reasonable certainty. By and large, however, and I think the thrust of the report of the city bar association was that effect, current law permits the accrual.

I know that hope springs eternal, and I think Ron Pearlman made a fair point in referring to the *Dickman* case in which, at least for gift tax purposes, the result in the interest-free loan case

is now reversed. Perhaps on the income side we will have a reversal of the old *Simpson Dean* case.

Here, however, we have a regulation defining all of the events. The committee concluded that the state of the law is such that the most you could say about the Internal Revenue Service's position on accrual is that there would be continued uncertainty for many years if they continue to litigate their concept of accrual, one which no court is accepting.

The committee report discusses the possibility of the service taking a different tact and arguing, which it apparently did not in most of these cases, that income has not been clearly reflected rather than arguing all the events.

We have concluded that should they make that argument, probably they would lose, so we would be left with uncertainty in the law. Moreover, the committee concluded that even a regulatory change would probably not overcome the long history of the cases' interpretation of the accrual basis of accounting. Basically, the thrust of our committee report was that in the areas in which there was abuse or a distorted result, there should be a change, and that that change would have to be a legislative change—which is really why we are here.

The report in fact contains a request for a hearing such as this.

I would now like to spend a minute or two on a couple of points about the relationship between what the perceived abuse is and what the administration's proposal is. At this time I am not speaking for the city bar, because the city bar does not have a proposal on this point.

It is an obvious point that the abuse relates to the fact that the payment is made at a time much later than the accrual. It is solely a function of time. An accrued item that accrues today that is paid in 2 years is one matter; if it is paid in 22 years, that is a different matter. It is irrelevant whether you can determine the amount exactly; it is solely a question of the timing.

That means that the question is one of the amount of the deduction. The IRS in its proposal concedes that if you could present-value the amount, that would be fine. That is too complicated in the Service's view and therefore the economic equivalent is to wait until the time of payment.

I would submit that that approach only responds to one part of the problem, which is the amount of the deduction, but it creates another problem which is a mismatching of income and expense. In most of these cases the income to which the item fairly relates is current income.

In order to determine the correct amount of the deduction, the Treasury is saying, wait until the amount is paid, in effect put the taxpayer on the cash basis. I think there has to be a lot of hard thought put to the question of whether we want to trade off a situation in which a current deduction which matches income with a deduction taken long after the related income, albeit a deduction in a more appropriate magnitude.

Let me close with a correlary to that, a point that we made in our committee report, which is don't throw out the accrual basis for everybody if the problem is one of timing. Perhaps you should defer accrual for a payment that is made only after a certain

period of time—I don't know whether that would be 3 years or 5 years or 6 years. For payments made in the relatively near future, say within 5 years, accrual basis accounting seems to have served quite well.

Payments to be made in the long distant future, 5, 7, 20 years, is a different case. It seems clear that the Treasury proposal does not make a distinction along those lines.

To pick up on something Bernie said, I think the problems associated with coming up with a discounted value can be overstated. I would just cite the asset side, which can be fairly said to be a discounted approach to basis. That is, depreciation is determined on the basis of cost irrespective of when the asset is paid for and the check is that, to the extent that cash is not paid, we have either interest being paid by the owner or, if interest is not being paid, we have imputed interest.

We have no problem with having an imputed interest number, which may or may not be the exact number. On the asset side I think imputed interest can be characterized as a present value approach.

I think the same type of approach may be possible on the liability side. Thank you.

[The prepared statement follows:]

STATEMENT OF VICTOR F. KEEN, ON BEHALF OF THE COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

My name is Victor F. Keen and I am a partner in the New York City law firm of Whitman & Ransom. I appreciate the opportunity to appear before the Subcommittee to testify on the subject of "premature accruals". I am appearing on behalf of the Committee on Taxation of the Association of the Bar of the City of New York.

On June 28, 1983 the Bar Committee issued a report captioned "Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and the Time Value of Money". A copy of this Report, of which I was one of the principal draftsmen, is appended to this statement.

Described below is a summary of the principal findings and recommendations of the Report as they relate to the subject matter of today's hearing.

BACKGROUND

Under the applicable regulations, deductions are allowable to an accrual basis taxpayer in the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy (the "all events" test).

The subject of the Report and of today's hearing relates to transactions which may provide an accrual basis taxpayer an opportunity to claim deduction for a liability in a year long preceding the one in which the liability must be paid. If and when such deduction is available, the tax reduction resulting from the current accrual may be substantial in relation to (or in some cases exceed) the present value of the deferred payment.

The Bar Committee considered the application of accrual accounting principles in the following instances: [1] (1) structured settlements, (2) supplemental unemployment benefits programs, (3) worker's compensation and (4) obligation relating to the reclamation of a strip mine.

The legal issues presented in the above cases are by no means identical. However, a review of the results in these areas disclosed to our Committee that in most instances the claimed accruals are probably available under current law notwithstanding challenges by the Service. Such challenges have been principally on the assertion by the Service that the liability of the taxpayer is in some sense "contingent", that the amount of the liability cannot be determined with reasonable accu-

[1] In additional to these items, the Report also discussed transactions involving original issue discount, imputed interest and related areas which are beyond the scope of today's hearing.

racy or that there must be a current liability to pay or to perform in order to establish the accrual. The Committee concluded that (1) substantial economic distortions may be produced under existing law in some of the above cases, (2) the subject deserves urgent attention and (3) legislative solutions may be required. The Committee did not, however, recommend any particular solution, nor has it considered the Administration proposal now under consideration.

The specific areas considered by the Report are discussed below.

Structured settlements

Structured settlements are settlements generally arising in the context of tort litigation and involving periodic payments over a number of years or a lump sum payable at some future date.

Section 104 of the Code excludes from income the amount of any damage award received on account or personal injuries or sickness. Thus, when a business is a defendant, damage awards are generally deductible as ordinary and necessary business expenses and the amounts received by the individual recipient are excludable from income under section 104. The Code specifically provides that no portion of such payment is to be treated as interest income. (Section 104(a)(2) as amended by Pub. L. No. 97-473).

The accrual problem in the case of a structured settlement can be demonstrated by the following example: Assume a case in which an injured party would accept a settlement of either $1,000,000 payable in 1984 or $3,000,000 payable in 1994. If the plaintiff could realize an after-tax return of 10.8 percent (an 18 percent investment return reduced by an effective tax rate of 40 percent), the plaintiff who accepted $1,000,000 in 1984 would realize a total of $2,788,673 at the end of ten years, $211,327 less than he would have if he accepted the $3,000,000 deferred payment. If the $3,000,000 were deductible in 1984, the taxpayer would realize a savings of approximately $1,500,000 by reason of the deduction. This $1,500,000 in taxes saved would be worth $3,890,614 in 1994 if the tax savings were invested in ten percent tax exempt bonds. Under these assumptions, the taxpayer would be in a better position than if it had not been sued.

The Committee concluded that in the above case the deduction would satisfy the "all events" test since:

(1) The fact of liability is absolute, being the subject of a court order or a contract;

(2) the amount of the liability and the time of payment is known;

(3) the identity of the recipient is known; and

(4) no future preformance by any party is required as a condition of making the payment.

In the view of the Committee, and undiscounted current deduction in such a case represents an unwarranted result.

Supplemental unemployment benefit cases

The *Lukens Steel* case permitted a deduction for amounts accrued in respect of Lukens; liability to pay benefits under a negotiated supplemental unemployment benefit ("SUB") plan. Under the plan, specified amounts were paid currently to a trust to fund benefits. In addition, the company agreed under its collective bargaining agreement to accrue two cents for each hour worked by eligible employees. This obligation was payable only when needed to fund benefit payments but, once incurred, could never be relieved; even if the SUB plan were terminated, the obligation continued until paid to employees.

The *Lukens* case was followed in several other cases (cited in the Report) concerning similar deductions claimed by accrual basis taxpayers. There are no cases denying an accrual basis taxpayer a deduction for SUB plan accruals.

In Revenue Ruling 72-34, the Service announced that it would not follow *Lukens*, concluding that the obligation was contingent and was not deductible until the time the taxpayer becomes currently obligated to pay.

Revenue Ruling 76-345, in which the Service announced that it would not follow the *Washington Post* case (a case similar to *Lukens*), held that to be "fixed" under the "all events" test, the liability must be owing to a specific individual. Under the ruling, accrual would be permitted only when a particular participant becomes entitled to payment.

It seems clear to the Committee that under current law as applied to the SUB cases, the "all events" test is met, notwithstanding:

(1) That the liability runs to a group (Whose composition may change) rather than to a specific individual; and

(2) That the time of future payment of the accrued liability is indefinite.

Worker's Compensation Act cases

The *Crescent Wharf & Warehouse* case dealth with employers' obligations pursuant to state worker's compensation acts to pay injured employees' medical expenses and disability benefits. The employer contended that the fact of the injury in an uncontested case was sufficient to fix liability for tax purposes, whereas the Service contended that liability was established only as medical service were rendered or a disabled employee's absence from work continued.

In reversing the Tax Court, the Ninth Circuit in *Crescent* held that the fact of injury itself sufficiently established liability to support the accrual. In *Wein Consolidated Airlines* the Ninth Circuit permitted a deduction for actuarially determinable survivors' benefits payable under a state workers' compensation act, holding that all events necessary to determine the liability had occurred at the employee's death.

In Revenue Ruling 80-191, the Internal Revenue Service announced that it would not follow *Crescent* or *Wien*, asserting that liability is established only upon medical treatment, continuance of disability or (in the case of survivor's benefits) continued survival of children.

The most recent decision in this area is *Kaiser Steel Corporation* v. *United States*, which allowed an employer to deduct the estimated amounts payable in future years as worker's compensation benefits with respect to injuries incurred during the taxable year.

As in the SUB cases, the Service has been uniformly unsuccessful in challenging accruals in the worker's compensation area. While the law seems relatively settled, the Committee notes that the worker's compensation cases present an issue not present in the structured settlement or SUB cases, namely, that the taxpayer's obligation could be said to be contingent on the future performance of medical services or the contined employment of the employee.

Strip mining cases

The Surface Mining Control and Reclamation Act of 1977, and similar state laws, impose certain reclamation requirements on surface mine operations. in *Ohio River Collieries Company* the Tax Court held that a strip-miner of coal could currently deduct reasonably estimated land reclamation costs which it was required by state law to pay after cessation of mining. The court placed principal reliance on *Lukens Steel.*

The Service disagrees with the result reached in *Ohio River Collieries* and believes that reclamation expenses are deductible only when there is a "present liability" to pay such expenses. Revenue Ruling 80-182, upon which such position is apparently based, holds that a lessee drilling from an offshore platform cannot deduct in advance its contractually mandated costs of removing the platform at the end of the lease term. (While there are no reported cases, the same issue is bound to arise in the future with respect to nuclear power plant decommissioning expenses, which are known from the start of construction to be legally required to be incurred at some time in the future.)

The essential question in the strip mining (and nuclear decommissioning) cases is the proper time to accrue an unconditional obligation to purchase services in the future. It can be argued that "all events" have not occurred until the service is in fact performed. While there is a present liability to pay someone in the future, there is no liability to pay anyone until someone performs the service.

On the other hand, strong arguments can be made in support of the result in *Ohio River Collieries.* The taxpayer will in fact be required to reclaim the land and, if one contractor fails to perform, the taxpayer will be required to find and pay another. On this theory, the event giving rise to the obligation to pay is the mining activity. (The applicable statute in *Ohio River Collieries* Provided that if the taxpayer failed to reclaim the land, the state would do so at the taxpayer's expense.)

However, even if the Service were ultimately to prevail in its view of the law, i.e., that accrual is denied because a future performance is required, a state could amend its law to require a strip miner to pay a predetermined minimum to reclaim the land. Under such a statute it would be difficult to deny the accrual on the ground that future performace is required.

In the case of strip-mining restoration expenses, the Committee believes that there is possible merit in the Service's view that the "all events" test should not be treated as met, although the cases do not support that view. Moreover, because of the duration of the deferral in the typical case, the Committee believes that immediate accrual can produce substantial economic distortion.

Section 446(b)—Clear reflection of income

The Committee notes that in most of the cases discussed above the Commissioner did not contest the accrual on the basis that income was not "clearly reflected" under section 446(b). The Committee does not, however believe that a generalized attempt to exercise section 446(b) authority would be either successful or appropriate. In the Committee's view such an approach would probably not be sustained in litigation absent corresponding changes in the applicable regulations or statute. The Committee is divided on the question of whether amended regulations along these lines would be upheld by the courts. In any event, the Committee believes that such a way of dealing with the problem would be likely to create an undesirable period of extensive litigation and uncertainty.

CONCLUSION

The Committee concludes, therefore, that legislation may be the most effective way of implementing a solution (or solutions) in those cases in which a current undiscounted deduction produces a distorted result.

TRANSACTIONS INVOLVING DEFERRED PAYMENT OF ACCRUED LIABILITIES: FEDERAL INCOME TAX AND THE TIME VALUE OF MONEY

by the Committee on Taxation of the Association of the Bar of the City of New York

Set forth below is the full text of a June 28, 1983 report which was prepared by a subcommittee of the Committee on Taxation of the Association of the Bar of the City of New York. The co-chairmen of the subcommittee were Victor F. Keen and John W. Weber, Jr. The names of the other members of the Committee are listed in the Appendix. The Committee wishes to express its gratitude to Dennis McCarthy of Coopers & Lybrand for his assistance with respect to matters of accounting. This report is reproduced with permission from a forthcoming edition of The Record of the Association of the Bar of the City of New York.

In this report, the Committee on Taxation discusses the application of accrual accounting principles for tax purposes to structured settlements, supplemental unemployment benefit and worker's compensation cases, strip mining cases, and cases in which discount obligations are issued without original issue discount. It concludes that in at least some instances the accruals permitted under present law are unwarranted.

The Committee then explores possible remedies for the problems arising under existing law. It first considers whether the Commissioner has regulatory authority under section 446(b) of the Code to require an accrual basis taxpayer to account for deferred liabilities in a way that would reduce or eliminate the time-value benefit produced by allowance of a deduction for liabilities payable in the distant future. It concludes that a generalized attempt by the Commissioner to exercise section 446(b) authority would not be successful or appropriate. For this reason, the Committee recommends that legislation be considered on an urgent basis that would more clearly reflect the time value of money for income tax purposes.

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TABLE OF CONTENTS

I. INTRODUCTION 699

II. THE ACCRUAL METHOD OF ACCOUNTING 700

III. APPLICATION OF ACCRUAL METHOD 701
- 1. 'Structured' Settlements 701
- 2. SUB and Worker's Compensation Cases 703
  - a. Supplemental Unemployment Benefit Cases 703
  - b. Worker's Compensation Act Cases 704
  - c. SUB and Worker's Compensation — State of the Law 705
- 3. Strip Mining Cases 705
- 4. Discount Obligations Issued Without Original Issue Discount 706
  - a. A Prototype 'No Original Issue Discount' Transaction 707
  - b. The Economic Effect of the Exchange 707
  - c. Discussion of Applicable Tax Rules 707
  - d. Scope of the Problem Remaining 709
- 5. Summary of the State of the Law 710

IV. SECTION 446(b) — CLEAR REFLECTION OF INCOME 710

V. CONCLUSION 712

I. INTRODUCTION

A topic of current interest to both tax practitioners and the Treasury Department[1] concerns transactions which provide an accrual basis taxpayer an opportunity to claim a deduction for a liability in a year long preceding the one in which the liability must be paid. In such a case, the tax reduction resulting from the current accrual may be substantial in relation to (or in some cases exceed) the present value of the deferred payment. In other words, if the tax savings were invested over the period between accrual and payment, the resulting fund could be large

[1] *See* Statement of John E. Chapoton, Assistant Treasury Secretary for Tax Policy, at Hearings held on December 7, 1982 by the Senate Finance Energy Subcommittee on S. 1911 and S. 2642, Mining Reclamation Bills, reported in Daily Tax Report No. 235 (December 7, 1982) at page J-1; Aidinoff and Lopata, *Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising From Obligations To Be Performed In the Future*, 33 Tax Lawyer 789 (1980). *See also* Statement of William S. McKee, Acting Deputy Assistant Treasury Secretary for Tax Policy, at Hearings held on May 23, 1983 by the Senate Finance Energy Subcommittee on S. 237, reported in Daily Tax Report No. 100 (May 23, 1983) at page J-5.

enough to pay most or all of the liability, and might even leave a "profit" to the taxpayer as a result of his incurring the expense.

In concept, similar time value disparities benefitting the taxpayer could exist on the income side. That is, an accrual-basis taxpayer could receive cash prior to the time it was required to be included in gross income. However, with certain legislated exceptions, such opportunities are rare under present law.[2]

On the other hand, a taxpayer could be required by the accrual method to accrue income well in advance of its actual receipt; although the report does not examine this problem, this disadvantage to the taxpayer must be kept in mind in examining the advantage to the taxpayer of early accrual of deductions.

The Committee is of the view that, if there were a structured settlement by an uninsured defendant, the law at present allows a full deduction to an accrual basis taxpayer since the "all events" test is met.... The Committee believes that a full up-front deduction in such a case represents an unwarranted result.

This report discusses the application of accrual accounting principles in the following instances in which deductions may be available with respect to liabilities incurred substantially before they are required to be paid: (1) "structured" settlements, (2) supplemental unemployment benefit programs and workmen's compensation, (3) reclamation obligations arising from strip mining and (4) discount obligations issued without original issue discount.

A review of the results in the above areas discloses that in most instances the claimed accruals are probably available under current law notwithstanding challenges by the Commissioner. Such challenges have been based principally on the assertion that all the events requisite to the determination of the fact and amount of liability had not occurred rather than that the accrual did not result in a clear reflection of income.

This report reaches the following conclusions and makes the following recommendation:

(1) In at least some instances, the accrual available under current law is unwarranted.

(2) Under present regulations, the Commissioner would probably not succeed in overturning the results in the cases he has lost by challenging on the basis that the accrual failed to clearly reflect income.

(3) The Committee is divided as to whether, in cases involving a liability where accrual antedates payment by a significant period of time, the courts would uphold revised regulations which required either a deferral of the deduction until time of payment or a discounting of the deduction to present value. The Committee believes that such regulations, even if valid, would probably be challenged and that their issuance would create an undesirable period of uncertainty.

(4) Since the reflection of time value of money for federal income tax purposes not only has potentially dramatic revenue implications but also involves fundamental principles of tax accounting applicable to a wide variety of transactions and taxpayers, the Committee believes that a comprehensive legislative or regulatory solution is called for and strongly recommends that high priority be given to the development of such a project. The Committee offers its assistance to the relevant government agencies in shaping a solution.

II. THE ACCRUAL METHOD OF ACCOUNTING

Generally, a deduction must be taken in the taxable year which is "the proper taxable year under the method of accounting used in computing taxable income"[3]; the computation of taxable income shall be made "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[4] The accrual method of accounting is expressly recognized to be a permissible method of accounting.[5] In fact, the regulations generally mandate such treatment for taxpayers utilizing inventories in their business.[6]

Deductions are allowable to an accrual-basis taxpayer according to the "all events" test first enunciated by the Supreme Court in *United States v. Anderson*.[7] This test is now reflected in the Treasury regulations, which state:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.[8]

Generally accepted accounting principles require accrual accounting to be employed in the conduct of most business enterprises. From a financial accounting

[2] In general, as discussed in more detail in Section IV of the text, by virtue of the doctrine associated with *Automobile Club of Michigan v. Comm'r*, 353 U.S. 180 (1957), *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961) and *Schlude v. Comm'r*, 372 U.S. 128 (1963), it is now well established that an accrual basis taxpayer is required to include in income in the year of receipt amounts received under an agreement to perform services in the future.

However, there are several statutory and nonstatutory exceptions to this general rule. For example, Rev. Proc. 71-21, 1971-2 C.B. 549, permits prepaid service income to be deferred until it is earned if all the services are to be performed by the end of the taxable year following the year of receipt. Similarly, Treas. Reg. §1.451-5 generally allows income received pursuant to an agreement to sell goods in a future year to be deferred until the year properly accruable under the taxpayer's method of accounting, providing the taxpayer uses the same method of accounting for both tax and financial purposes. Statutory exceptions to the rule that an accrual basis taxpayer must currently take into account prepaid income are found in §455 (prepaid subscription income is includible in income ratably over the taxable years in which the liability to provide a newspaper, magazine or other periodical exists), and §456 (prepaid dues may be ratably included in income over the period that the taxpayer is required to provide services if such period does not exceed 36 months).

[3] I.R.C. §461.

[4] I.R.C. §446(a).

[5] I.R.C. §446(c).

[6] Treas. Reg. §1.446-1(c)(2)(i).

[7] 269 U.S. 422 (1926).

[8] Treas. Reg. §1.461-1(a)(2). *See also* Treas. Reg. §1.446-1(c)(1)(ii).

viewpoint, the objective of the accrual method of accounting for expenses is to match liabilities incurred to the period to which they relate, even if later paid, just as the objective of the accrual method of accounting for income is to relate that income to the period in which earned, even if later received. It is well established that financial accounting principles do not govern tax accounting determinations;[8] however, even acknowledging the bias of financial accounting towards minimizing income,[9] reference to the financial accounting treatment of transactions may be appropriate in determining what constitutes a clear reflection of economic results.[10]

III. APPLICATION OF ACCRUAL METHOD TO SPECIFIC CASES INVOLVING LIABILITIES TO MAKE DEFERRED PAYMENTS

1. "Structured" Settlements

"Structured" settlements—settlements generally arising in the context of a tort litigation and involving periodic payments over a number of years or a lump sum payable at some future date—have been discussed in various articles.[11] However, there has been only limited exploration of their tax treatment.

The Committee is divided as to whether . . . the courts would uphold revised regulations which required either a deferral of the deduction until time of payment or a discounting of the deduction to present value.

Section 104 of the Internal Revenue Code (the "Code") excludes from income the amount of any damage award received (whether by suit or agreement) on account of personal injuries or sickness. Thus, when a business is a tortfeasor, damage awards which it pays are generally deductible as ordinary and necessary business expenses, and the amounts received by the individual recipient are excludable from income under section 104.

In the late 1970s the Internal Revenue Service (the "Service") dealt with structured settlements from the point of view of the recipient and concluded that periodic payments pursuant to such settlements were excludable from income in full and that no portion thereof was to be treated as interest income.[12] This position has now been confirmed legislatively.[13]

In a recent article,[14] a case is assumed in which an injured party will accept a settlement of either $1,000,000 payable in 1981 or $3,000,000 payable in 1991. The author, assuming that the plaintiff could realize an effective after-tax return of 10.8 percent (an 18 percent investment return reduced by an effective tax rate of 40 percent), concludes that the plaintiff who accepted $1,000,000 in 1981 would realize a total of $2,788,673 at the end of ten years, $211,327 less than he would have if he accepted the $3,000,000 deferred payment. The author also points out that, assuming the $3,000,000 is properly accruable for tax purposes, the tortfeasor would realize a savings of approximately $1,500,000 by reason of such $3,000,000 deduction. The approximately $1,500,000 in taxes saved by the time that the $3,000,000 is due in 1991 will be worth $3,890,614 if the tax savings were invested in ten percent tax-free bonds. Thus, under the above assumptions, by 1991 the tortfeasor would be in a better[15] position than if it had not been sued.

The article then examines the legal authorities relevant to the allowability of the deduction and concludes that

[8] *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522 (1979).

[9] *See RCA v. United States*, 664 F.2d 881 (2d Cir. 1982), *cert. denied*, 102 S.Ct. 2958 (1983).

[10] See the discussion in Section IV of the text.

[11] *See, e.g.*, Henderson, *Periodic Payments of Bodily Injury Awards*, 66 American Bar Association Journal 734 (1980); Corboy, *Structured Injustice: Compulsory Periodic Payment of Judgments*, 66 American Bar Association Journal 1524 (1980); Krause, *Structured Settlements for Tort Victims*, 66 American Bar Association Journal 1527 (1980).

[12] Rev. Rul. 77-230, 1977-2 C.B. 214 (amounts paid to an injured person from trust established by the United States are excludable under §104(a)(2) whether from income or corpus); Rev. Rul. 79-220, 1979-2 C.B. 74 (payments received under single premium annuity contract purchased by insurance company to fund damage settlement excludable from recipient's income under §104(a)(2)); Rev. Rul. 79-313, 1979-2 C.B. 75 (series of increasing payments excludable under §104(a)(2)).

[13] Section 101(a) of Pub. L. No. 97-473 amended section 104(a)(2) of the Code to specifically provide that the exclusion from gross income of amounts received as compensation for personal injuries or sickness applies whether the amounts are paid as a lump sum or as periodic payments. Section 102(a) of Pub. L. No. 97-473 also added a new section 130 to the Code, which provides that an amount received for agreeing to undertake an assignment of a liability to make periodic payments as personal injury damages is excluded from gross income to the extent it is used to purchase an annuity or an obligation of the United States if the annuity or obligation is designated to fund the periodic payments and the purchase is made within 60 days before or after the date of the assignment. Section 130 thus reverses the position taken by the Service in LTR 8248073 (August 31, 1982).

[14] McGown, *Structured Settlements: Deduct Now and Pay Later*, 60 Taxes 251 (1982).

[15] Some have suggested that if the $3,000,000 deferred payment actually resulted in an after-tax profit to the defendant, the defendant would offer to settle for an even greater amount so as to increase his benefit. The Committee is not convinced that this kind of maneuvering is likely for a public company, or, as a practical matter, would be considered by a private company or an individual. Furthermore, applying generally accepted accounting principles, a defendant could not show the entire tax benefit on an income statement presented to shareholders or creditors. Rather, the deduction would be reflected as a deferred tax credit taken into income ratably as the structured payments are made.

In any event, if the amount of damages to be paid were increased by a defendant, the Service would have a basis for denying the deduction on the ground that the payments were not ordinary and necessary as required under §162. Further support for an attack on the deduction would be found in cases such as *Goldstein v. Comm'r*, 364 F.2d 734 (2d Cir.), *cert. denied*, 385 U.S. 1005 (1966) (interest actually paid nondeductible because payments had no purpose beyond reducing taxes).

there is a good chance that the deduction for $3,000,000 would be allowed in the year the agreement was entered into and that, accordingly, the economic results outlined would obtain.

The Committee's view is that "all events" requisite to accrual would be satisfied in the year of the settlement if the following conditions exist:

(1) The fact of liability were absolute, being the subject of a court order or a contract;
(2) The amount of the liability and the time of payment were known;
(3) The identity of the recipient or group of recipients were known; and
(4) No future performance by any party were required as a condition of making the payment.

Under section 446(b), an otherwise "acceptable" accounting method can be disregarded if income is not "clearly reflected." Unless the Commissioner is authorized to override the accrual under the authority of that section, it appears to the Committee that an obligation pursuant to a structured settlement would be currently deductible. As indicated in Section IV below, the Committee believes that under existing law the Commissioner would probably not succeed in a challenge of such deduction based upon section 446(b). The Committee believes that a full up-front deduction in such a case is unwarranted. However, for the reason indicated below, based on a limited investigation of the practical aspects of structured settlements, the Committee has concluded that the time value of money possibilities arising from the allowance of accrual-basis deductions for structured settlements may not necessarily present a major problem.

First, the Committee is informed that it is generally not feasible for an uninsured defendant to utilize a structured settlement. In practice, structured settlements have almost invariably involved agreements between a casualty insurance company (which is honoring its obligation under an insurance policy covering the defendant) and the plaintiff. In the typical case, the casualty company will acquire an annuity policy from a life insurance company to fund the structured settlement. The casualty company may or may not be required to guarantee the obligation of the insurance company. The insurance policy is generally owned by the casualty company. In such cases, the amount of the structured settlement and the possible difference between an up-front payment of the liability and the structured settlement will have no effect on the defendant (whose deduction is limited to insurance premiums paid). The effect would be solely on the tax position of the casualty insurance company. While this depends on the tax laws peculiar to casualty insurance, a subject presently under study in Congress and beyond the scope of this report, it appears that a casualty insurance company may be permitted to deduct currently the undiscounted value of a liability to pay a future claim.[17]

Second, even assuming that an uninsured defendant would enter into a structured settlement, the Committee questions whether the assumptions upon which the above example is based are accurate and realistic. In the first place, it is doubtful that an injured party would agree to a total deferral for a period as long as 10 years—particularly for a benefit of only $211,327. Both the literature and the Committee's experience indicate that a more realistic example of a structured settlement is one in which level annual payments are made over a period of years. Thus, a more meaningful comparison might be between an agreement by the tortfeasor to pay $300,000 per year for 10 years and an agreement to make a present payment of $1,800,000.[18] In such a case, if the tortfeasor were to earn a 17.35 percent after-tax yield on the tax savings resulting from the $3,000,000 current deduction, it could make the required annual payments without having to use other funds.

The reflection of time value of money for federal income tax purposes . . . has potentially dramatic revenue implications . . . .

To illustrate the point another way, assume that a corporate taxpayer is permitted a $3,000,000 deduction on January 1 and is not required to make the payments of $300,000 until December 31 of that year and each succeeding year (for a total of 10 years). On January 1, the federal income tax saving from the current deduction has a present value of $1,380,000. The flow of payments of $300,000 each year for 10 years has a present value cost of $1,843,370 (assuming a 10 percent after-tax discount rate).[19] Thus, the net present value cost to the tortfeasor is $463,370 (present value cost of $1,843,370 less $1,380,000 present value of current deduction). By contrast, if a present payment of $1,800,000 were made the tax saving from the resulting deduction would be $828,000, leaving a present value cost to the tortfeasor of $972,000. Thus, the tortfeasor may save approximately $509,000 by virtue of being able to utilize the installment payment option.

It is unlikely that a plaintiff would accept a structured settlement which consists only of the tortfeasor's unsecured promise to pay. The Committee is informed that

[17] See Statement of John E. Chapoton, Assistant Treasury Secretary for Tax Policy, at Hearings held on June 13, 1983 by the Senate Finance Committee on Taxation of Property and Casualty Insurance Companies, reported in Daily Tax Report No. 114 (June 13, 1983) at pp. J-2—J-3.

[18] The present value of a payment of $300,000 a year for 10 years at a 10 percent (after-tax) discount rate is $1,843,397. Thus, assuming such a rate, the current payment of $1,800,000 and the $300,000 per year for 10 years are approximate economic equivalents. Assuming that the agreement to pay $300,000 a year over 10 years is deductible in the amount of $3,000,000 in the year the agreement is entered into, and that the tortfeasor is in a 46 percent bracket, the deduction will save $1,380,000 in taxes. Each year a portion of this saving and the earnings thereon will theoretically be available to make the required $300,000 payment.

[19] A 10 percent after-tax rate is assumed in the McGown article. This assumption may seem high based on current rates. A lower rate would reduce the net benefit of a structured settlement as compared to a lump sum payment, since it would increase the present value cost of the stream of $300,000 installment payments without changing the benefit of the immediate tax deduction.

in a structured settlement, an uninsured defendant would probably be required to fund the promise to pay the plaintiff with an annuity (or endorsement) policy written by a recognized insurance company. (Indeed, section 130 of the Code, discussed above, seems designed expressly to facilitate this process.) Presumably, this protects the injured party from the possibility of the defendant's bankruptcy. In this event, while the tax benefit remains unchanged, the effective cost to the payer depends not upon its internal rate of return or its borrowing costs but upon the cost of acquiring the required insurance policy.

The Committee has concluded that the time value of money possibilities arising from the allowance of accrual-basis deductions for structured settlements may not necessarily present a major problem.

It is possible that some tortfeasors might secure their promise to pay structured settlements by a stand-by letter of credit from a bank or similarly financially responsible party. This also would have its own associated cost.

If a structured settlement on the basis set forth above were agreed to, based upon a ten percent after-tax discount rate, a payment of $1,843,370 (plus costs and profit to the insurance company) would be required to be made to the insurance company. (Assuming a 10 percent after-tax discount rate, payments of $300,000 a year have a present value cost of $1,843,370.) Where the defendant remains obligated to the plaintiff after payment to the insurance company in such a case, the Committee believes that $3,000,000 would be the amount of the current deduction, as long as not precluded by section 446(b). However, the cost analysis presented above would still apply. Thus, if it were feasible for an uninsured tortfeasor to work out a structured settlement backed by insurance, the after-tax saving of $509,000 projected for an uninsured plan (less insurance company profit, etc.) would be available.[20]

The Committee understands that both financial analysis and the accounting profession would recognize a current expense only to the extent of the present value of the deferred payments. This creates a dichotomy. The claiming of a full deduction in the year a structured settlement is entered into is consistent with section 446(a), but, if the financial analysts' and accountants' method of reflection were to be accepted for tax purposes, the accrual would not clearly reflect income and might thus be disregarded under section 446(b).

The Committee is of the view that, if there were a structured settlement by an uninsured defendant, the law at present allows a full deduction to an accrual basis taxpayer since the "all events" test is met. (The possibility that the Commissioner could alter this result by exercising authority under section 446(b) is discussed in Part IV.)

The Committee believes that a full up-front deduction in such a case represents an unwarranted result. It is divided, however, on whether the likelihood of abuse by uninsured tortfeasors is great enough to justify remedial action. Some Committee members believe that the economic benefit of the current accrual of a full deduction for a typical structured settlement, as compared to the economic benefit which would be derived from annual deductions for the payments as made, is not sufficiently great to justify concern that the tax aspects of structured settlements will predominate over the economic consequences. Other members of the Committee believe that significant economic distortion can result and that unjustified use of the structured settlement will increase unless corrective steps are taken.

2. Supplemental Unemployment Benefit and Worker's Compensation Cases

a. Supplemental Unemployment Benefit Cases. *Lukens Steel Company v. Comm'r*,[21] held deductible amounts accrued for Lukens' liability to pay benefits under a negotiated supplemental unemployment benefit ("SUB") plan. Under the plan, specified amounts were paid currently to a trust to fund benefits. In addition, the company agreed under its collective bargaining agreement with the United Steelworkers of America to accrue on its books, in a "contingent liability account,"[22] two cents for each hour worked by eligible employees (until a maximum financing target was reached). This obligation was payable to the trust only when needed to fund benefit payments but, once incurred, could never be relieved; even if the SUB plan were terminated, the obligation continued until paid to employees.

The Third Circuit affirmed the Tax Court's holding that under the accrual method of accounting Lukens was entitled to deduct not only payments to the trust fund but also amounts accrued in the "contingent liability account" on its books. Quoting the statement in the Court of Claims opinion in *Washington Post Co. v. United States*,[23] that the "all events" test requires only the certainty of the liability "and not necessarily either the certainty of the time over which payment will be made or

[20] It should be noted that the mathemati[illegible]he example in the text is slightly more complicated when an insurance policy is purchased. Since an 18 percent pre-tax investment return is assumed, $1,843,370 would actually purchase a ten-year annuity of $410,177 per year. The defendant would be taxed on the earnings of the policy, (cf. Treas. Reg. §1.61-13) for a tax liability of 46 ($410,177—$184,337), or about $105,000, leaving about $300,000 per year to make the payment to defendant. Since the full $3,000,000 had been deducted initially, no annual deduction would be allowed.

It should also be noted that for any given level of annuity payments promised to a plaintiff, not only the defendant (as illustrated above) but also the plaintiff benefits by the retention of the policy by defendant (rather than initial transfer to plaintiff). If defendant retains the policy, the entire amount is tax-free to plaintiff; if the policy were transferred initially, part of each payment would be taxable to plaintiff. Cf. Rev. Rul. 79-220, 1979-2 C.B. 74.

[21] 442 F.2d 1131 (3d Cir.), *aff'g* 52 T.C. 764 (1969).

[22] While the accounts were referred to in the agreements as "contingent," the court pointed out that, in fact, the liability to make the payment was subject to no contingencies (other than the passage of time).

[23] 405 F.2d 1279 (Ct. Cl. 1969).

the identity of the payees," the Court concluded that "[u]nder all the facts we are satisfied that uncertainty of the time of payment is not of such importance to the [SUB] Plan as to warrant reversal."[24]

The opinion in *Lukens* stresses that the SUB arrangement was the result of hard bargaining, carefully worked out upon the basis of a comprehensive statistical analysis of relevant cost factors and unemployment experience. The opinion recites that it was "assumed" and "anticipated" that payments from the "contingent liability account" would be required within a few years.

Chief Judge Hastie's concurrence in *Lukens* would have limited the court's holding by specifically relying on the finding of the Tax Court that it was probable and reasonably anticipated that the sums deducted would have to be paid out within a relatively short time that could be estimated approximately.

> That finding makes it unnecessary to decide whether sums committed to such a fund as this are then immediately deductible as an accrued business expense if the time of future disbursement is entirely speculative and is as likely to occur decades hence as in the near future. Yet the opinion of the Court seems broad enough to cover that situation.[25]

The *Washington Post* case relied on by the Third Circuit involved the accrual of a liability for payments to news dealers upon terms which, though leaving the time of payment indefinite, seemed to involve an anticipated deferral period similar to that typical of deferred compensation plans. The accruals in *Washington Post* included annual credits in the nature of interest on the balance of the liability.

The *Lukens* case was followed in several other cases concerning similar deductions claimed by accrual-basis taxpayers for SUB plan deductions.[26] With the possible exception of two such cases,[27] both of which refused to inquire into actual pay-out experience, Judge Hastie's attempt to limit the holding in *Lukens* has not been explicitly rejected, and from the reported facts of the remaining cases, it appears unlikely that long periods of deferral were involved. There are no cases denying an accrual basis taxpayer a deduction for SUB plan accruals.

In Revenue Ruling 72-34[28] the Service announced that it would not follow the *Lukens* decision on the grounds that:

> (1) Where there exists a contingency as to payment of an obligation, and such contingency relates to other than the ability of the obligor to pay, it cannot be said that the obligation is fixed within the meaning of section 1.461-1(a)(2) of the regulations, and
>
> (2) Where a contingency as to payment of an obligation is created at the same time and in the same instrument establishing the debt, or where they are [sic] otherwise concurrently created in a related transaction, that contingency invades [sic] liability as well as timing of payment. Accordingly, in such cases, for that portion of the liability not paid out by the taxpayer but rather retained for use in the business, no deduction will be allowed until that time when the taxpayer becomes currently obligated to make an actual cash payment. . . .[29]

Revenue Ruling 76-345,[30] in which the Service announced that it would not follow the *Washington Post* decision, emphasized that to be "fixed" under the "all events" test, the liability must be owing to a specific individual. Thus, accrual is permitted only when a particular participant becomes entitled to payment. The ruling did not stress the factor of delay in payment.

In general, the Committee believes that the courts' interpretation of the 'all events' test is correct in the SUB cases. . . .

The teachings of the SUB cases may be summarized as follows:

(1) The fact that an accrued liability runs to a group (whose composition may change), rather than to a specific individual, does not bar a deduction under the "all events" test;

(2) The fact that the time of future payment of an accrued liability is indefinite does not, by itself, bar a deduction under the "all events" test;

(3) Judge Hastie's concurrence in *Lukens* suggests that in an extreme case where the future payment of an accrued liability will be long delayed, a deduction under the "all events" test might be denied; and

(4) The IRS continues to contest proposition (1), although not clearly enunciating its position on propositions (2) and (3).

b. Worker's Compensation Act Cases. *Thriftimart, Inc. v. Commissioner*,[31] and *Crescent Wharf & Warehouse Co. v. Commissioner*,[32] dealt with employers' obligations pur-

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[24] 442 F.2d at 1135. *Compare Reynolds Metals Inc. v. Comm'r*, 68 T.C. 943 (1977), where up to 13 years elapsed between accrual and full payment on a first-in-first-out basis, the Tax Court stated: "We cannot say, if the time period for payment were so stretched out as to render the ultimate liability a practical nullity, that our conclusion would remain the same." *Id.* at 960.

[25] 442 F.2d at 1135.

[26] See *Cyclops, Inc. v. United States*, 408 F. Supp. 1287 (W.D. Pa. 1976); *Inland Steel Co. v. United States*, 212 Ct. Cl. 558 [76-2 USTC para. 9791] (1976); *Inland Steel Co. v. United States*, Ct. Cl. Trial Div. [80-2 USTC para. 9833] (1980); *Crucible, Inc. v. United States*, 591 F.2d 643 [79-1 USTC para. 9164] (Ct. Cl. 1979); *Timkin Co. v. United States*, [78-2 USTC para. 9553] (Ct. Cl. 1978); *Reynolds Metals Co.*, 68 T.C. 943 (1977). *Cf. Zwicker Knitting Mills v. United States*, Ct. Cl. Trial Div. [80-2 USTC para. 9832] (1980) (deduction allowed for accrual under negotiated employee welfare plan); *Rath Packing Co. v. Bacon*, 255 F. Supp. 809 (S.D. Iowa 1966) (same with respect to negotiated automation study plan).

[27] *Timkin Co. v. United States*, [78-2 USTC para. 9553] (Ct. Cl. 1978); *Crucible, Inc. v. United States*, 591 F.2d 643 [79-1 USTC para. 9164] (Ct. Cl. 1979).

[28] 1972-1 C.B. 132.

[29] *Id.*

[30] 1976-2 C.B. 134.

[31] 59 T.C. 598 (1973).

[32] 59 T.C. 754 (1973), *rev'd*, 518 F.2d 772 (9th Cir. 1975).

suant to worker's compensation acts to pay injured employees' medical expenses and disability benefits. In both cases the Tax Court held that injuries in the taxable year were inadequate to satisfy the "all events" test and that liability was established only as medical services were rendered or a disabled employee's absence from work continued. In *Crescent*, the Tax Court analogized medical treatment or continued disability to the continued performance of services under an employment contract for which liability was accruable only as the services were rendered.[31]

In reversing and remanding *Crescent* for determination of whether the amount of the liability was determinable with reasonable accuracy, the Ninth Circuit held that the injury itself sufficiently established liability. The court stated that, so long as the amount is determinable, accrual and deduction in the year of injury achieves the "most logical correlation of income to expenses."

Prior to the above decisions, Revenue Ruling 70-262,[33] had refused a deduction for actuarially determinable survivors' benefits payable under a state worker's compensation act because the possibilities of death or remarriage, either of which would terminate the employer's obligation, precluded the establishment of liability. On identical facts, *Wien Consolidated Airlines, Inc.*,[34] held that all events necessary to determine the liability had occurred at the employee's death and allowed a deduction for benefits payable to surviving children. *Thriftimart* and *Crescent* were distinguished on the grounds that those cases involved conditions precedent rather than conditions subsequent (a less than totally satisfactory distinction).

In Revenue Ruling 80-191,[35] the Service announced that it would not follow the Ninth Circuit's decisions in *Crescent* and *Wien*. This ruling makes no reference to conditions precedent or subsequent, but reasserts that liability is established only upon medical treatment, continuance of disability or continued survival of children.

The most recent decision in this area is *Kaiser Steel Corporation v. United States*,[36] which allowed an employer to deduct the estimated amounts payable in future years as worker's compensation benefits with respect to injuries incurred during the taxable year. Finding that the "all events" test was met and the amount determinable,[37] the court stressed that accrual of the deduction in the year in which the injury was sustained most clearly reflects income and that requiring deferral of the deduction until payment would distort income and would constitute an abuse of the Commissioner's discretion. The court accorded no apparent significance to the fact that payment of the worker's compensation benefits accrued in the taxable year extended over at least seventeen years.

c. SUB and Worker's Compensation—State of the Law. In general, the Committee believes that the courts' interpretation of the "all events" test is correct in the SUB cases and that neither a definite time for payment nor an identified payee is a prerequisite for allowance of a deduction to an accrual basis taxpayer. The Committee notes, however, that the worker's compensation cases present an additional issue, in that the taxpayer's payments may be contingent on the future performance of medical services or the continued employment of the employee. The effect of contingencies of this type on the availability of the accrual is discussed in more detail below in connection with the accrual of expenses of strip-mining reclamation.

The Committee also believes that there may be cases in which the time for making compensation or employee welfare payments is so indefinite or remote that the Commissioner may be entitled to invoke section 446(b), discussed in section IV.

3. Strip Mining Cases

A more difficult issue concerning the "all events" test is raised by the "strip mining" cases. Most recently, *Ohio River Collieries Company*[38] held that a strip-miner of coal could currently deduct reasonably estimated land reclamation costs which it was required by state law to pay after cessation of mining. Principal reliance was placed on the *Lukens Steel* decision discussed above.

Recent congressional testimony by Treasury officials against proposed legislation which would codify the result reached in *Ohio River* was to the effect that the Treasury disagrees with the result reached in that case under present law and believes that reclamation expenses are deductible only when there is a "present liability" to pay for such expenses.[39] Revenue Ruling 80-182,[40] upon which such testimony is apparently based, holds that a lessee drilling from an offshore platform cannot deduct in advance its contractually mandated costs of removing the platform at the end of the lease term. The testimony indicates that the Treasury apparently reaches the same result whether the obligation to incur a future expense arises as a matter of state law or of private contract. While there are no reported cases, the same issue will certainly arise in the future with respect to nuclear power plant decommissioning expenses, which are known from the start of construction to be legally required to be incurred at some time in the future.

In analyzing the issues raised by this type of fact pattern, the Committee believes that it is essential to "strip away" several peripheral issues.

First, in *Ohio River*, it was stipulated that the future expenses could be determined with reasonable accuracy, satisfying that prong of the "all events" test. To eliminate this prong of the test as an issue, it may be assumed that a legal or contractual obligation exists which requires the operator to eventually spend a fixed amount on restoration.

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[32] 1970-1 C.B. 262.

[33] 60 T.C. 13 (1973), *aff'd.* 528 F.2d 735 (9th Cir. 1976).

[34] 1980-2 C.B. 168.

[35] 82-2 USTC para. 9635 (N.D. Calif.) (1982) (appeal to 9th Cir. pending).

[36] While finding that the taxpayer "could and did determine its individual and aggregate worker's compensation liability as of [the end of the taxable year] with 'reasonable accuracy'" the opinion expressly rejects, as being inconsistent with Treas. Reg. §1.461-1(a)(2), any requirement that workmen's compensation liabilities be accrued on a case-by-case basis.

[37] 77 T.C. 1369 (1980) (reviewed with no dissents).

[38] *See* Statements of John E. Chapoton and William S. McKee, *supra* at note 1. This rationale is very similar to that of Rev. Rul. 72-34, 1972-1 C.B. 132 (holding that the Service will not follow the SUB cases) and of Rev. Rul. 80-191, 1980-2 C.B. 162 (holding that the Service will not follow the workmen's compensation cases).

[39] 1980-2 C.B. 167.

Second, in *Ohio River* it was agreed by the government that the reclamation costs were properly deductible as a business expense, rather than being capital expenses. (To the extent that the mandated expenses were required eventually to be spent in a way that would increase the value of the land to the operator, they would be capital, nondeductible expenditures even when paid, and thus could not be deducted at any time. The government's concession in *Ohio River* must therefore be based on the premise that the expense, when paid, would provide no benefit to the mining company except the relief of its statutory obligations.)[41]

Third, *Ohio River* is distinguishable from the SUB cases such as *Lukens Steel* (the principal case relied on in *Ohio River*) because there the reclamation services to be rendered had not been received at the time the liability was incurred.

There may be cases in which the time for making compensation or employee welfare payments is so indefinite or remote that the Commissioner may be entitled to invoke section 446(b)....

Fourth, it seems clear that if the mandated payments were simply an obligation to make a lump-sum payment to the state upon the completion of mining (or to make the payment to the lessor in the case of a lease as in Revenue Ruling 80-182), the "all events" test would be met. In that case, the liability would be similar to that in the structured settlement cases, *i.e.*, a fixed obligation to make a fixed payment in the future, with the payer receiving nothing in return. This is similar to a fixed tax obligation payable in the future, or an obligation to pay accrued rent at a future date. Again, *Ohio River* is distinguishable because the obligation there was to pay for services to be provided to the payer in the future.

The essential question remaining unanswered by the foregoing is the proper time to accrue an unconditional obligation to incur in the future a fixed expense which will purchase services which are of no benefit to the purchaser (but are of a benefit to a third party). This is a difficult question. On the one hand, it can be argued that as a technical matter, "all events" cannot be said to occur until the service is in fact performed. While there is a present liability to pay *someone* in the future to have the service performed in the future, there is no liability to pay *anyone* until *someone* performs the service. From the very beginning of the income tax, this type of expense was not considered deductible in advance.[42]

On the other hand, strong arguments can be made that *Ohio River* is correct. The taxpayer will in fact be required to reclaim the land, and if one contractor fails to perform, the taxpayer will be required to find and pay another. On this theory, the event giving rise to the obligation to pay is the mining activity, and there is no doubt that *someone* can be found who will accept payment for performing the required services. (In fact, the statute in *Ohio River* provided that if the taxpayer failed to reclaim the land, the state would do so at the taxpayer's expense.) This view is supported by *Harrold v. Commissioner*,[43] and *Denise Coal v. Commissioner*.[44]

The Committee does not take a position on this controversy, or on the proposed legislation to codify the result reached in *Ohio River*. The Committee points out, however, that if the Treasury is correct as to present law, a state could easily amend its law to assure advance accrual of this type of expense. For example, the law could simply provide that a strip miner would be required to pay a predetermined minimum to reclaim the land, with any excess of this minimum over actual cost going to the state. Thus, even a Treasury victory in litigation on this question would not eliminate the potential distortion caused by the accrual.

One further issue arises in this type of situation where services are to be performed in the future. Suppose that the reasonably estimable reclamation costs in today's dollars are $1,000, but reclamation will not occur for ten years. Assume that the best estimate of inflation in service costs is 10 percent per year (meaning that reclamation will cost $2,600 ten years hence). The economically correct deduction in this situation is $1,000 (the present value of $2,600 ten years hence). In fact, this result will be reached under the "all events" test if inflation adjustments are not considered to be reasonably estimable, leaving $1,000 as the only certain expense. Only if inflation in costs is taken into account, therefore, will the deduction in the first year be $2,600. It is possible that the Treasury could reach substantially the result it desires in this area by taking the position that future inflation can *never* be determined with reasonable accuracy, and that, in effect, only the current dollar equivalent of future service costs may be deducted.

4. Discount Obligations Issued Without Original Issue Discount

If a borrower issues a debt obligation at an issue price which gives rise to original issue discount, as defined in section 1232(b)(2), there are two basic consequences: (1) the holder of the debt—even if otherwise a cash basis taxpayer—must include the original issue discount in taxable income progressively over the term of the debt (ratably in the case of obligations issued on or before July 1, 1982, and on a compounding basis in the case of later-issued obligations);[45] and (2) the discount is amortized and deducted by the issuer on a matching basis.[46] Any amount received by a holder upon sale or exchange (including retirement) of the debt obligation in excess of the includible original issue discount is treated as capital gain if the obligation is held as a capital asset.[47]

[41] This would be the case, for example, if the taxpayer did not own the mined land, or if the land was worthless after the coal was removed.

[42] *See Harris Emery Co. v. Comm'r*, 10 B.T.A. 297 (1928), O.D. 516, 2 C.B. 112 (1920), *dec'd obsolete*, Rev. Rul. 68-575, 1968-2 C.B. 187.

[43] 192 F.2d 1002 (4th Cir. 1951), *rev'g* 16 T.C. 134.

[44] 271 F.2d 930 (3d Cir. 1959).

[45] I.R.C. §§1232, 1232A.

[46] Treas. Reg. §1.163-4; I.R.C. §163(e).

[47] I.R.C. §1232(a)(1).

In a substantial number of cases, however, debt obligations which are issued at an economic discount are issued without original issue discount as defined in section 1232(b).[47] Most notably, when debt obligations are issued in exchange for property and are not "traded on an established securities market," their issue price is deemed to be the "stated redemption price at maturity"—thus barring original issue discount by definition. This rule also applies to securities issued in a recapitalization or other reorganization so long as neither the security issued nor the security surrendered is publicly traded.[48] Before December 13, 1982, original issue discount was not created on securities issued in a tax-free reorganization even if the securities were publicly traded.[50]

a. A Prototype "No Original Issue Discount" Transaction. The foregoing original issue discount rules have made it possible for issuers to design transactions involving the exchange of debt securities for other property, including outstanding securities of the same issuer, at an economic discount, but without original issue discount as defined in section 1232(b). Of the many possible varieties, the most widely publicized is a type of transaction known sometimes as a "deferred interest debt exchange" and sometimes as a "zero coupon bond recapitalization."

The first of these to draw widespread attention was an issuance of Guaranteed Deferred Interest Debentures by Exxon Shipping Corporation in September, 1982 in exchange for two outstanding note issues. In this transaction, each of the previously outstanding notes (the "Old Notes") had a principal amount of $1,000 and, by reason of the high interest rates prevailing at the date of the exchange, a fair market value of approximately $650 to $675. For each Old Note, Exxon Shipping issued debentures ("Debentures") having an apparently equal fair market value and the following features:

- Aggregate Principal Amount per $1,000 Old Notes: $5,670.
- Maturity: 30 years.
- Interest Rate: Slightly more than 9 percent per annum, simple interest, deferred and payable at maturity (or upon earlier default).
- Total Payments: None until maturity; at maturity, a total payment of $21,000, representing $5,670 of principal and $15,330 of interest.[51]

While the tax consequences of this type of transaction are not free of doubt, the Committee understands that the consequences which the parties hope to achieve—expressed in terms of the facts of the Exxon transaction—are as follows:

(1) The exchange of Debentures for Old Notes will constitute a recapitalization within the meaning of section 368(a)(1)(E).

(2) Consequently, the Debentures are issued without original issue discount as defined in section 1232(b)(2).[52]

(3) As to a cash-basis holder of a Debenture:
   (a) No income will be recognized until payment is received (or collectible) upon maturity of the Debenture;
   (b) The amount of stated interest—$15,330—will be taxable as ordinary income; and
   (c) The remaining $5,670 of the payment, to the extent exceeding the holder's basis, will also be taxable, but possibly as a long-term capital gain.

(4) As to the issuer:
   (a) No cancellation of indebtedness income will be recognized upon the exchange;
   (b) The stated annual interest on the Debentures is deductible as it accrues each year; and
   (c) "Retirement premium," equal to the excess of the principal amount of the Debentures over the principal amount of the Old Notes, may be amortized and deducted ratably over the life of the Debentures.

b. The Economic Effect of the Exchange. The advantages of such a transaction to the issuer are substantial, assuming that the expected tax consequences are realized. Over a 30-year period, it will claim deductions for accrued interest and amortizable retirement premium on a ratable basis, but will make no cash payments until the thirtieth year. The tax savings achieved by the deduction in the first year will be available for actual or hypothetical investment for a full 29 years, and so on. This is, of course, more favorable than paying cash interest on a current basis; and the deductions—being based on a ratable portion of the discount—exceed the amounts allowable under the "real yield" method which would apply under section 1232A if a zero coupon obligation had been issued in exchange for cash. Moreover, for financial accounting purposes, the issuer is permitted to reduce the debt appearing on its balance sheet by the difference between the face amount of the surrendered securities ($1,000 in the Exxon case) and the fair market value of the securities issued in exchange ($650 to $675 in the Exxon case) and to record an equivalent gain.

c. Discussion of Applicable Tax Rules. With only minor qualification,[53] there is little doubt that the issuance by an

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[47] I.R.C. §1232(b)(2) (last sentence).

[48] I.R.C. §1232(b)(4), added by the Technical Corrections Act of 1982, Pub. L. No. 97-448, §306 (1982). Where the security surrendered has a fair market value less than face, its issue price is considered to be its fair market value for the purposes of computing original issue discount.

[50] I.R.C. §1232(b)(2), as in effect prior to its amendment by the Technical Corrections Act of 1982.

[51] *See* Prospectus dated September 10, 1982 at 4. A similar transaction was entered into by at least one other issuer, General Motors Acceptance Corporation (*see* Prospectus dated December 15, 1982). Arlen Realty & Development Corp. had earlier, pursuant to an Offering Circular dated April 23, 1982, offered holders of its outstanding subordinated debentures a somewhat similar exchange for new zero coupon debentures. The transaction had several distinguishing characteristics, however, since the new debentures, which bore no stated interest, were convertible into stock and, at the option of the company, were payable in stock upon maturity.

[52] Since the Exxon transaction pre-dated the Technical Corrections Act of 1982, the "publicly traded" limitation did not apply. See text accompanying notes 57-59, *infra*.

[53] It has been suggested that, if only a small fraction of the total issue of outstanding securities were surrendered, such exchange might not qualify as a recapitalization. While there is no direct authority which would limit in this respect the qualification of a debt-for-debt exchange as a recapitalization, the regulations give as an example of a qualifying recapitalization a surrender of 25 percent of a corporation's outstanding preferred stock in exchange for common. Treas. Reg. §1.368-2(e)(2). This has been thought to raise some inference that the Service might consider exchanges of a smaller fraction of an outstanding issue not to represent the requisite "reshuffling" of the corporation's capital structure. *See Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942).

issuer of new securities in exchange for its outstanding securities constitutes a recapitalization under section 368(a)(1)(E). It has been suggested that the Service may dispute this,[54] presumably by reason of the role played by the investment bankers. In those transactions which have been done, the issuer's investment banker has gone into the market to purchase and collect the outstanding securities, has made the actual exchange with the issuer and then has sold the new securities in the market.[55] While the continuity of interest requirement does not apply to recapitalizations,[56] the concern has been that the investment banker might be deemed the agent of the issuer when it purchases the old securities for cash. It seems questionable, however, whether such a characterization could be sustained, since the issuer neither uses nor agrees to supply its own cash in the exchange and receives no cash in the end; while the investment banker may hold the exchanged securities only briefly, it utilizes its own funds to purchase and takes whatever risk there is that the sale of the new securities in the market will compensate it for its efforts.

Assuming that there is a valid tax-free recapitalization, the issuer will recognize no gain or loss, and no cancellation of indebtedness income as long as the principal amount of the newly issued securities exceeds that of the debt retired. There will also be no original issue discount under the law applicable to transactions effected prior to December 13, 1983. For transactions occurring on or after that date, there will still be no original issue discount if neither the securities surrendered nor those issued in exchange are traded on an established securities market.

It is not clear as of what time the "not traded" requirement must be met. Presumably, if the outstanding securities were publicly traded, the fact that an investment banker bought them up so that there was no trading immediately before the exchange would not qualify the transaction for the "not traded" exception.[57] Assuming that the surrendered securities were privately held (as, in fact, they were in the Exxon Shipping case), it is the "not traded" status of the new securities which is critical. Under the existing regulation,[58] an obligation is treated as traded on an established securities market if it is so traded within ten trading days after the date of its issuance; presumably, if it is not so traded within that period, it will not be considered to be publicly traded.[59]

In cases where there is no original issue discount within the meaning of section 1232(b)(2), it is not entirely clear what body of law governs the tax consequences to the accrual-basis issuer. There is no question that the issuer has incurred borrowing costs—stated interest and the excess of principal amount payable at maturity over the principal amount of the obligations at the time of issuance (referred to as "retirement premium"). Even though the payment of these amounts is deferred until maturity, it appears that the requirements of the "all events" test are met: the fact of liability is absolute, its amount and time of payment are known precisely, the identity of the obligee—though it may change by reason of transfers—is limited to the particular holder of the security, and no future performance by the holder or any other party is a condition to payment.[60] Two questions then arise: first, whether any principle of tax law overrides the general accrual rule in this context; and second, on what kind of a schedule the borrowing costs may be accrued.

A . . . difficult issue concerning the 'all events' test is raised by the 'strip mining' cases.

A radical line of attack on the deductibility of both stated interest and the retirement premium could be derived from the regulations under sections 1232 and 163. In the transactions discussed here, there is no original issue discount because under section 1232(b)(2) the issue price is *ipso facto* deemed equal to the "stated redemption price at maturity." This is, in turn, defined to include "dividends, interest, and any other amounts, however designated, payable at that time."[61] It could be argued that by definition, therefore, there is nothing for the issuer to deduct; it is deemed to have issued—again borrowing from the facts in the Exxon transaction—a non-interest-bearing obligation having a redemption price at maturity of $21,000 for an issue price of $21,000. In functional terms, such an assertion would be premised on the theory that sections 1232 and 1232A are preemptive, that section 163 implicitly incorporates this concept and that economic discount on obligations is either deductible in accordance with the terms of those sections or not at all. Support for such a position may be found in the Tax Court's decision in *Seaboard Coffee Service, Inc. v. Commissioner*.[62] There it was held that no interest-like deduction was available to the issuer of a debt obligation in exchange for property (in that case, stock) under circumstances where there was no original discount under section 1232(b)(2).

This might, of course, prove too much. The issuer could be denied any deduction for borrowing costs which obviously are borne, and the holder—if symmetry is to prevail—would have nothing to include in income. On the other hand, if section 1232 is read to mean that the obligation by definition has neither amortizable discount nor stated interest, then section 483 might act to impute

[54] See GMAC Prospectus at 6.

[55] The same result could be achieved if the holders of the outstanding securities first effected the exchange and then sold the newly issued securities to the investment banker.

[56] Rev. Rul. 77-479, 1977-2 C.B. 119; Rev. Rul. 77-415, 1977-2 C.B. 311.

[57] *Cf.* Rev. Rul. 75-117, 1975-1 C.B. 273.

[58] Treas. Reg. §1.1232-3(b)(2)(iii)(b)(3) (second sentence).

[59] *See* Private Letter Ruling 8322070 (March 2, 1983).

[60] The Committee understands that there is substantial doubt that, if the issuer were to become bankrupt prior to maturity, the bankruptcy court would allow as a claim any amount in excess of amounts accrued in an economic sense, that is, on the slower compounding basis. If so, a faster, ratable accrual may not be proper under the "all events" test. The balance of the discussion assumes, however, that the "all events" test would be deemed satisfied as to the full extent of the accrued payments computed on a straight line basis. Contrast the discussion of strip-mine reclamation costs at pp. 19-23, *supra*.

[61] Treas. Reg. §1.1232-3(b)(2)(iii)(a).

[62] 71 T.C. 465 (1978).

interest . . . in which event the issuer would be entitled to deduct this interest amount—but only when it becomes payable at maturity."[64]

If this "no discount" theory is rejected, it is unclear whether deduction by the issuer in accordance with normal accrual-basis rules could be successfully challenged. By stating interest at the "safe harbor" rate of 9 percent per annum or more, the parties appear to shield their transaction from interest imputation under section 483, and—incongruous though it seems—nothing in that provision either makes the availability of the 9 percent simple interest "safe harbor" dependent on current payment of the interest or defers the time of deduction of stated interest if payment is not current, as is done with respect to imputed interest.

In these recapitalization transactions, it is apparent that the amount of stated interest has been chosen solely to avoid the application of section 483; in the market the issues are "priced" on the basis of their total yield to maturity, which includes not only the stated interest but also the retirement premium. The designation of a 9 percent interest rate is thus highly artificial. Nothing in section 483 suggests any limitation on the freedom of the parties to choose this rate, however. As discussed below, the retirement premium may be deductible on essentially the same basis as the stated interest, so that the distinction may be meaningless to the issuer. (As to the holder, the retirement premium is arguably taxable as a long-term capital gain by virtue of section 1232(a)(1).)

There is authority pre-dating the first enactment of section 1232 which supports the amortization of retirement premium over the life of the obligation.[65] While these cases upheld ratable amortization, they are uncertain authority for that particular amortization schedule since it was the Commissioner who argued for ratable amortization, while the taxpayer argued for full deduction at the time of issuance; thus, the rate or basis of amortization could be said not to have been at issue.

The Committee does not believe that a generalized attempt to exercise section 446(b) authority would be either successful or appropriate.

Although sections 1232A and 483 may be technically inapplicable, the Commissioner could exercise his authority under section 446(b) (discussed in Part IV below) to require these items to be deducted under a section 1232A-like schedule, on the ground that the recent enactment by Congress of that section provides authority as to what deduction pattern satisfies the "clear reflection of income" criterion. In Revenue Ruling 83-84,[66] the Service held that no deduction for interest will be allowed for any year in excess of "economic" accrual in the case of a loan agreement providing that interest shall be earned according to the rule of 78's. Economic accrual for a given period is determined under the ruling by applying the effective rate of interest to the unpaid balance for such period. Among other authorities, the ruling referred to section 461(g) (prepaid interest) and section 446(b) (clear reflection of income), as well as the economic accrual concept embodied in section 1232A.

The basic conclusion which emerges from this discussion, however, is that, barring the assertion of the harsh "no discount" theory described above, an accrual basis issuer appears entitled to amortize borrowing costs—interest and retirement premium—over the life of the obligation. Unclear, especially in light of the position taken in Revenue Ruling 83-84, is whether the Commissioner will assert that the deduction is limited to the amount of interest which has accrued economically (rather than ratably) and, if so, whether such position would be upheld by a court.

d. Scope of the Problem Remaining. As indicated above, this recapitalization technique is no longer available when either the surrendered or the newly issued securities are "traded on an established securities exchange." Even though this rule will apply to securities which are traded almost immediately after their issuance,[67] the private issuance of securities in exchange for privately held securities can apparently still be accomplished, and an issuance will apparently be considered private if trading of the new securities is held off for a relatively brief period of time. More importantly, perhaps, recapitalizations are not the only type of transaction to which the considerations discussed above can apply. The absence of original issue discount arises because section 1232(b)(2) specifies that, if not regularly traded, securities issued in exchange for any kind of property (other than money) are deemed to have an issue price equal to the stated redemption price.

Assume, for example, that a corporation wished to purchase $650,000 of depreciable machinery. Suppose that the corporation's investment banker offered to acquire the machinery and transfer it to the corporation in exchange for $5,670,000 principal amount of debentures having the same terms as in the Exxon Shipping transaction (30 years' maturity, 9 percent simple interest payable at maturity). Two months later, the underwriter makes a public offering of the debentures. It is arguable that this transaction results in the corporation's acquiring a $5,670,000 basis in machinery having a value of only $650,000.[68] If ACRS deductions were allowable on this basis, the financial benefit to the corporation would far exceed the already substantial benefits of accruing interest deductions for amounts not payable for 30 years, while offering cash-basis investors freedom from section 1232A accrual of original issue discount.

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[64] The regulations provide: "Except [for the publicly traded rule] if an obligation . . . is issued for property other than money . . . no original issue discount is created as a result of the exchange. However, in such cases there may be an amount treated as interest under section 483." *Ibid.*

[65] Treas. Reg. §1.483-2(a)(1)(iii).

Great Western Power Co. v. Comm'r, 297 U.S. 543 (1936); *South Carolina Continental Telephone Co.*, 10 T.C. 164 (1948).

[66] Rev. Rul. 83-84, *reprinted in Daily Tax Report* (June 6, 1983) at H-1.

[67] *See* text at notes 57-59, *supra*.

[68] *See* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 4.06 at 4-19—4-21 (4th ed. 1979).

In this situation, however, the basis of property may be limited to less than the face amount of the debt obligation issued. If the transaction is deemed to give rise to unstated interest under section 483, the basis of the property received in exchange for the indebtedness will not include the unstated interest amount.[69] In tax-shelter sale and leaseback cases courts have held that nonrecourse debt obligations, issued as purported payment for property in amounts substantially in excess of the fair market value of the property, may be disregarded as not constituting *bona fide* indebtedness.[70] It would, however, require a substantial extension of the holdings of these cases to sustain a similar attack where the debt obligation is issued with full recourse; the cited cases depended in substantial part for their rationale upon the fact that the purchaser issuing nonrecourse debt in effect had no real investment in the property nominally acquired and therefore could abandon it at any time without economic loss. In the transaction hypothesized above, the indebtedness is real and must be paid in accordance with its terms; to this extent, the issuer has a real investment in the property to the same extent as any taxpayer incurring debt in connection with a purchase. It is possible, however, that in the situation described, the basis is in any event limited to the fair market value of the property.[71]

Even if the basis of the property acquired were limited for purposes of depreciation or ACRS allowance to its fair market value, the question would remain of how the issuer of the obligations treats the difference between this figure and the amount payable at maturity; this seems to involve the same issues discussed above in connection with recapitalization transactions.

5. Summary of the State of the Law

In the SUB and worker's compensation cases and in the strip mining cases the Commissioner has taken the position in litigation that an accrual basis taxpayer could not deduct the liability in question substantially before it was paid, based upon a failure to meet the "all events" test. In these areas the Commissioner has lost the argument at least as often as he won it. In both the worker's compensation and SUB areas the Commissioner has issued a revenue ruling stating that he disagrees with the unfavorable case law; the Commissioner has also issued a ruling directly contrary to the rationale of the strip-mining cases he has lost. In addition, legislation has been proposed to confirm the results of the most recent strip-mining case favorable to the taxpayer. While structured settlements and the issuance of discount debt without original issue discount have not been the subject of any litigation, it is not unlikely that the Commissioner may seek to rule adversely or litigate at least some of the tax issues involved.

In view of these rather checkered results, the question arises whether it would be possible to introduce certainty into the law and perhaps to protect the fisc through the issuance of regulations stating that in certain circumstances, accrual basis taxpayers will not be allowed to deduct until paid a liability which will not be paid within a specified period of time. Alternatively, the regulations could provide for a current deduction for only the discounted value of certain liabilities payable on a long-term deferred basis. The following portion of the report discussing section 446(b) of the Code considers whether it would be appropriate for the Commissioner to issue such regulations and whether such regulations would be upheld by the courts.

IV. SECTION 446(b) — CLEAR REFLECTION OF INCOME

The Committee has noted that in most of the cases discussed above, the Commissioner has not contended that the accrual should be denied under section 446(b) on the basis that income was not clearly reflected. The next portion of the report discusses whether the Commissioner has authority under section 446(b) to require an accrual basis taxpayer to account for deferred liabilities in a way which would reduce or eliminate the time value benefit produced by the allowance of a deduction for the face amount of a liability payable in the distant future.

As discussed above, section 446(a) provides that taxable income shall be computed by using the method by which the taxpayer "regularly computes his income in keeping his books."[72] Section 446(c) prescribes the following permissible methods: the cash receipts and disbursements method, the accrual method, any other method permitted by the Code, or any combination of the foregoing as permitted under regulations prescribed by the Secretary.

Section 446(b) provides an exception to these general rules:

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

The discretion provided to the Commissioner by section 446(b) is reflected in the regulations, which provide (at Treasury Regulations section 1.446-1(b)(1)) that:

> If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

Other sections appear to limit somewhat the exercise of the Commissioner's discretion in this area. Treasury Regulations section 1.446-1(a)(1) provides that:

> Except for deviations permitted or required by such special accounting treatment [*i.e.* the accounting

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[69] *See* Treas. Reg. §1.483-1(a)(1)(i); *Rev. Rul. 82-224, 1982-52 I.R.B. 5 (Dec. 17, 1982).*

[70] *See e.g., Estate of Franklin v. Comm'r*, 544 F.2d 1045 (9th Cir. 1976), *aff'ing* 64 T.C. 752 (1975); *Odend'Hal v. Comm'r*, 80 T.C. ___ No. 29 (March 31, 1983); *Hager v. Comm'r*, 76 T.C. 759 (1981).

[71] *See* note 68, *supra*; Private Letter Ruling 8323037 (March 8, 1983), supplementing Private Letter Ruling 8251097 (Sept. 22, 1982), which held that the basis of real estate purchased for a 30-year, 9 percent interest-bearing note was the fair market value of the property acquired rather than the face amount of the note. (The ruling did not disclose the payment terms of the note.)

[72] For these purposes, the term "books" refers to records, ledgers and journals rather than financial statements. *See Patchen v. Comm'r*, 258 F.2d 544 (5th Cir. 1958); *Brooks v. Comm'r*, 6 T.C. 504 (1946).

> treatment for certain items such as soil and water conservation expenses], taxable income shall be computed on the basis on which the taxpayer regularly computes his income in keeping his books.

Further, the regulations at section 1.446-1(a)(2) provide a description of what clearly reflects income:

> A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted principles or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all terms of gross income and expense are treated consistently from year to year.

Generally accepted accounting principles require that a contingent obligation to make payments at some time in the future shall be recorded as an expense in the profit and loss statement if it is probable that a liability has been incurred as of the date of the financial statement and if the amount of the liability may then be reasonably estimated. This treatment is mandatory, even if the identity of the payee is unknown. If the time of payment is unknown as of the date of the financial statement, accrual of the full amount of the future payment is required. If the time of the payment is known, accrual of the discounted present value of the future payment is required for financial accounting purposes.

Thus, in the case of a structured settlement, since both the time and amount of the future payments are usually known at the time of settlement, accrual of the discounted present value of these payments is appropriate. With respect to an obligation to make future payments of supplemental unemployment benefits, worker's compensation costs or strip mining land reclamation costs, the amount of the future payments will generally be susceptible of reasonable estimate at the time the liability is incurred, but the time of payment will be uncertain. Thus, accrual of the full amount of the future payments is required for financial accounting purposes.

Based solely on the Code and Regulations quoted above, an argument could be made that if in keeping his books the taxpayer follows a method of accounting which

(a) Reflects the consistent application of generally accepted accounting principles in accordance with accepted conditions or practices in that trade or business, and

(b) Treats consistently from year to year all items of gross income and expense,

that method will be deemed to clearly reflect income and shall be the method used to compute taxable income.[7] In such a circumstance, it could be argued that under existing regulations the Commissioner does not have discretion to change the taxpayer's accounting method. There is some support in the case law for that view.

For example, in *Auburn Packing Co. v. Commissioner*[8] and *W. P. Garth v. Commissioner*,[9] the Tax Court upheld the taxpayer's method of inventory valuation against the Commissioner's section 446(b) attack. Both cases held that the Commissioner cannot require the taxpayer to change from one method that clearly reflects income to another that also does so. In both instances, the Tax Court gave great weight to the testimony of the taxpayer's expert witnesses to the effect that its accounting method clearly reflected income. *See also Fort Howard Paper Co. v. Commissioner*,[10] (for 35 years the taxpayer had capitalized only the direct costs of labor associated with self-constructed assets; under the circumstances this was a generally accepted method of accounting that clearly reflected income).[11] However, these cases are not concerned with the accrual of long-term liabilities. One case was found which apparently upheld the taxpayer's treatment of a long-term liability against the Commissioner's section 446(b) attack. *Denise Coal Co. v. Commissioner*.[12] Therein the court stated:

> The taxpayer on an accrual system of accounting will not have his books 'clearly reflect' the state of his income if he does not make such a reserve, and the statute requires that a taxpayer's books shall 'clearly reflect' his income.... We think it is good business and good accounting and, therefore, ought to be good tax law to allow a reasonable estimate to be set up as a reserve for the fulfillment of this statutory obligation.

The *Denise Coal* case provides a significant precedent that would be favorable to the taxpayer in resisting the Commissioner's attempt to characterize the accrual in a strip mining case as one that does not clearly reflect income; the other taxpayer victories discussed above would provide somewhat weaker authority.

The Committee has concluded that the subject of the reflection for income tax purposes of the time value of money is one which deserves urgent attention.

Notwithstanding the foregoing, it appears that limitations on the Commissioner's discretion under section 446(b) have not been clearly established. The Commissioner's authority to require a change in the taxpayer's method of accounting does not appear to be purely a

[7] Cf. Treas. Reg. §1.446-1(a)(2).
[8] 60 T.C. 784 (1973).
[9] 66 T.C. 610 (1976).

[10] 49 T.C. 275 (1967).
[11] As an illustration of the vagaries of this area, the *Fort Howard* case should be compared with *William K. Coors*, 60 T.C. 368 (1973), *aff'd*, 519 F.2d 1280 (10th Cir. 1975). In *Coors*, the Tax Court upheld the Commissioner's exercise of discretion under section 446(b), and both direct and indirect costs of labor associated with self-constructed assets were required to be capitalized. The Tax Court distinguished the *Fort Howard* case on the theory that in *Coors* a substantial number of employees devoted the major part of their time to a construction program, whereas in *Fort Howard* the repair and maintenance staff worked on self-constructed assets during its idle time. Thus, the cases could be read together as indicating that the validity of the exercise of the Commissioner's discretion depends on whether or not the employees constructed the assets in their spare time.
[12] 271 F.2d 930 (3rd Cir. 1959).

question of how accurate or appropriate the method is in a technical accounting sense.

The courts have exercised wide discretion in substituting their judgment for that of the taxpayer and his accountants. The only objective constraints on the court's discretion in this area are those of consistency with the prior case law[79] and a duty imposed on the Commissioner not to apply the accounting rules arbitrarily.[80]

It is theoretically possible for the Treasury to deal with certain time value of money problems by asserting authority under section 446(b) to disallow a deduction for accruals occurring more than a specified period prior to payment or, alternatively, to allow only the discounted value to be deducted.

A classic example of the scope of the discretion of the courts and the Commissioner in this area is found in *Mooney Aircraft Inc. v. United States*,[81] a case concerning the accrual of a long-term liability. Therein, the Commissioner's discretion under section 446(b) was upheld in circumstances in which the taxpayer promised to pay $1,000 when each of the aircraft it sold was taken out of service. The court held that the "all events" test for accrual was satisfied. However, it also held that the Commissioner's denial of the deduction was appropriate:

> In what sense, then, is it [the accrual of the liability] an accurate reflection of income to regard it as an expense of doing business in the current year? To so regard it is to let an accounting fiction obscure the business and fiscal realities that are the heart of this case. In exercising his discretion the Commissioner need not close his eyes to these realities and to the actual facts.

Perhaps the clearest example of the fact that the Commissioner has the ability to override accrual accounting under section 446(b) if he can persuade a court to substitute his views of what clearly reflects income for those of the taxpayer and its accountants is found in *American Automobile Association v. United States*.[82] In that case, the taxpayer accrued prepaid dues during the period for which it was obliged to perform services on the basis of an admittedly accurate statistical dispersion. The Commissioner argued, and the court agreed, that the taxpayer should be on the cash basis with respect to the prepaid item.

[79] *See, e.g., RCA v. U.S.*, 664 F.2d 881 (2d Cir. 1981), holding that the *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961) (discussed at note 2, *supra*) case discussed above supported the Commissioner's exercise of discretion under section 446(b) to require the taxpayer to report income from service contracts on the cash method.

[80] *See Bay State Gas Co. v. Comm'r*, 681 F.2d 1 (1st Cir. 1982), holding that the taxpayer was not required to accrue income with respect to gas sold (but not yet paid for) to its "budget billing" customers where the Commissioner does not require such an accrual with respect to gas sold to other customers.

[81] 420 F.2d 400 (5th Cir. 1969).

[82] 367 U.S. 687 (1961).

The *AAA* case is particularly illuminating in that t Court of Claims had found as fact that the ta paye method of accounting had been used regularly sin 1931, was in accord with generally accepted accounti practices and was customarily employed in the indust These facts would seemingly have been sufficient meet the tests prescribed under section 1.446-1(a)(2) the regulations and could have supported a holding th the taxpayer's method of accounting clearly reflecte income. The court found, however, that the taxpaye method of accounting did not clearly reflect incor stating:

> This is only to say that in performing the function of business accounting the method employed by the Association 'is in accord with generally accepted commercial accounting principles and practices.' It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury.

The *AAA* case involved the accrual of income. It unclear the extent to which the broad language of th case would be applied in a case involving the override o the accrual of a deduction where the "all events" test met.

As indicated above, it is theoretically possible for th Treasury to deal with time value of money problems suc as those described in this report by asserting authorit under section 446(b) to disallow a deduction for accrual occurring more than a specified period prior to paymen or, alternatively, to allow only the discounted value o the accrual to be deducted. On the one hand, the analysis found in *AAA* and in *Mooney Aircraft* could be said t support such a conclusion. On the other hand, the case law discussed above allowing such an accrual (whetho or not the issue was specifically raised) provides strong evidence that courts do not find such an accrual in- appropriate. On balance, the Committee does not believe that a generalized attempt to exercise section 446(b) authority would be either successful or appropriate. It would provide, in effect, too drastic a change in the current tax system to be sustained in litigation absen corresponding changes in the applicable regulations or statute.

V. CONCLUSION

The transactions discussed in Part III above by no means exhaust the list of those in which the accrual method may result in an inadequate recognition for income tax purposes of the time value of money. They are sufficient to persuade the Committee, however, that substantial economic distortions may be produced under existing law in some important cases.

In the case of structured settlements, clearly a large measure of the tax-attractiveness of such transactions results from the recently reaffirmed exclusion from the recipient's taxable income of the entire amount of an award or settlement, even when a substantial element thereof represents income economically attributable to the deferral. In practice, it appears to the Committee that the bulk of the cases involve insured liabilities, and thus the taxation of insurance companies, a matter which is beyond the scope of this report. To the extent that significant uninsured cases exist, however, the Committee's view is that the ability of the tortfeasor to accrue currently the full amount of the settlements will create

significant economic distortion if those settlements take the form suggested in the literature.

The Committee believes that the position of the Service in the SUB cases (that the "all events" test is not satisfied) is difficult to justify under existing law and the Committee is not convinced that such cases involve significant distortions where the period of time between accrual and payment is not excessively long. (The accrual issue presented in the worker's compensation cases, such as *Kaiser Steel*, presents a somewhat more difficult question.)

In the case of strip-mining restoration expenses, the Committee believes that there is merit in the Treasury Department's view that the "all events" test is not satisfied. Moreover, because of the duration of the deferral in the typical case, the Committee believes that immediate accrual can produce substantial economic distortion.

Finally, the Committee believes that substantial distortion can result from the "no original issue discount" transactions if they are accorded the tax consequences which the participants anticipate.

Accordingly, the Committee has concluded that the subject of the reflection for income tax purposes of the time value of money is one which deserves urgent attention. It has also concluded that, while the Internal Revenue Service and the Treasury Department can take some interim steps to deal with particular types of transactions, a comprehensive solution is called for.

The Committee concludes . . . that legislation may be the most effective way of implementing a comprehensive solution.

The alternatives do not seem promising from the government's point of view. In the case of uninsured structured settlements, the Committee is not sure that a substantial basis exists under existing law for denying the accrual, and the Commissioner has not challenged such accrual in litigation or published ruling. Litigation has produced an unbroken string of losses in the SUB cases (justifiably, in the Committee's view), as well as in the worker's compensation cases (where the issue appears to the Committee to be less clear-cut). The government seems similarly to be headed toward defeat in the strip-mining cases (although in the Committee's opinion the government's position may be more defensible under existing law). While the tax consequences of the "no original discount" transactions have not been litigated and the government may have a substantial chance of successfully contesting the tax consequences, reliance on litigation to restrain the proliferation of transactions of this genre seems unrealistic.

As discussed below, the Committee has concluded that the prospects of dealing with the perceived problems in a comprehensive way through issuance of regulations are uncertain.

In dealing with "no original issue discount" transactions, the Commissioner would appear to have the authority under section 483(c)(1) to prescribe that the "safe-harbor" interest rate established thereunder shall be computed on a compounding basis where payment is deferred. Moreover, if the issuer of such an obligation is entitled to amortize the retirement premium inherent in the "no original issue discount" obligation, the exercise of regulatory authority under sections 163 and 446(b) to require this amortization to conform to the compounding schedule prescribed by section 1232A would, in the Committee's judgment, probably be upheld as a valid exercise of the Commissioner's authority to require "clear reflection" of income.[62] It is not clear, however, whether these changes would be sufficient to solve all aspects of the "no original issue discount" problem.

In addition, the Commissioner might attempt to exercise the section 446(b) authority by publishing regulations which would deal with a broad range of time value of money problems—for example, by commuting allowable accrual deductions to a present value figure or by deferring accruals until a specified time before actual payment. The Committee is almost evenly divided on the question of whether such an attempt would be upheld by the courts as valid. However, the Committee believes that such a way of dealing with the problem would, in any event, be likely to create an undesirable period of extensive litigation and uncertainty. The Committee concludes, therefore, that legislation may be the most effective way of implementing a comprehensive solution.

Accordingly, the Committee recommends that the Treasury Department, the Service and the staff of the Joint Committee on Taxation undertake a comprehensive study of this general issue to ascertain how it might most appropriately be addressed by legislation or (although the Committee has reservations about such approach) in regulations. In this study, a broad range of options could be examined. Although the Committee is not prepared to make specific recommendations at this time, it has identified several approaches which warrant study, as well as several pitfalls in each.

The first might be called the "matching" approach, similar to that adopted in section 404, which allows deductions for deferred compensation payments only when the compensation is included in income by the (ordinarily cash-basis) recipient. Such a response may be useful in some other contexts, but in the broad range of financial and investment transactions, the "matching" approach could prove ineffective because of the ease with which parties could arrange to deal with tax-exempt entities or financial institutions or foreign persons taxed at low effective rates—to whom the timing of taxable income inclusions may not matter or may matter substantially less than the timing of the corresponding deductions. The history of leasing and other financial transactions demonstrates the relative ease with which third parties may be inserted into transactions when this improves the tax results to the other participants. (In the case of structured settlements, every recipient is "tax-exempt," since there never is an inclusion in taxable income.)

A second approach would be to follow the lead of economists and financial analysts and allow an accrual deduction for a future obligation only in an amount equal to the present value of the obligation. While conceptually

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[62] As indicated in the text accompanying note 66, *supra*, the Commissioner in Rev. Rul. 83-84 has disallowed accrual of interest deductions based upon the rule of 78's to the extent that the deductions exceeded "economic" accrual, in part on the authority of §446(b).

defensible, this approach would raise formidable practical problems. Deriving a present value requires the adoption of a discount rate; since internal rates of return vary substantially from business to business, prescribing a single rate might produce substantial inequities. Moreover, for accruals of items payable at an indefinite time, as in the SUB and strip-mining areas, such approach would not be feasible since the period over which the discount rate was to be applied would be unknown. Moreover, because of the intimate connection between accrual-basis accounting for debt obligations and the inclusion of debt in the computation of the basis of assets (for purposes of capital recovery and other tax purposes), the effects on this cognate area of tax law must be considered.

A final approach might be simply to limit the accrual of deductions to those involving obligations which will be paid within some specified period of time. If this approach were adopted, care would have to be taken not to interfere with normal commercial practices. Thus, a reasonably short period of deferral of payment—for example, a few years—might be permitted without loss of the right to accrue. Here again, it appears that a substantially arbitrary rule would be required, and this might work unfairness in specific cases.

Further analysis may, of course, indicate that one type of solution is more appropriate for some situations, while another solution seems preferable for others. For example, in the case of structured settlements, the economic distortion arises from the ability to deduct amounts which economically constitute interest before that interest is paid or properly accruable. The application of the "imputed interest" approach of section 483 to reduce the current deduction to what is in fact a present value figure, while allowing later deduction of the interest amounts, may prove a relatively direct and effective solution. (This is the fashion in which section 483 currently operates in sales or exchanges of property, reducing basis for purposes of investment tax credit and ACRS deductions by imputed interest amounts.)** At the same time, this may not be an appropriate solution for other cases, such as the SUB and worker's compensation cases, where the time of payment is indefinite; in such cases, deferral of the deduction if accrual antedated payment by a significant period of time might be preferable.

Despite the difficulty of shaping an acceptable response, the Committee reiterates its conviction that a solution should be sought and offers its assistance in any efforts which the interested government agencies may undertake.

**Rev. Rul. 82-224, 1982-52 I.R.B. 5 (Dec. 17, 1982).

Association of the Bar of the City of New York

COMMITTEE ON TAXATION

Set forth below is the roster of the Committee on Taxation of the Association of the Bar of the City of New York. Several of the persons listed below made substantial contributions to the writing of this report.

Chairman: David R. Tillinghast

Members of the Committee:

Burton M. Abrams
Martin B. Amdur
Richard G. Cohen
Harvey P. Dale
Robert S. Enright
M. Carr Ferguson, Jr.
Fred Feingold
Stephen D. Gardner
Ralph A. Gerra, Jr.
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William F. Indoe
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Arthur L. Kimmelfield
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Matthew M. McKenna
Michael Schler
Stuart H. Simon
John Y. Taggart
J. David Voss
John W. Weber, Jr.

Chairman RANGEL. Mr. Sunley.

STATEMENT OF EMIL M. SUNLEY, DIRECTOR OF TAX ANALYSIS, DELOITTE, HASKINS & SELLS (FORMER DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, DEPARTMENT OF THE TREASURY)

Mr. SUNLEY. Mr. Chairman, members of the committee, it is indeed a pleasure to appear again before this subcommittee. Let me begin by summarizing the administration's approach to this so-called premature accrual problem. First, a deduction now is worth more than a deduction later because of the time value of money. This is true.

Second, to make the value of a tax deduction now equal to the value of a tax deduction later requires some discounting. This also is true.

Third, discounting can be complex, and this is true.

Fourth, the administration concludes that companies should only deduct liabilities when economic performance occurs. This does not follow. It does not take into acount that liabilities to make payments in the future are not all the same type.

The administration advances a complex proposal which would require every accrual-method taxpayer to determine whether actual economic performance, however defined, has occurred. This would substantially increase the complexity of the accrual method of accounting.

My testimony today is not a legal analysis of whether or not a future payment meets the all-events test for a current deduction under the accrual method. Instead I want to examine the economic reality of particular payments to see what would be a reasonable tax treatment for them.

My framework is a simple one: If a tax is going to be imposed on income, it is necessary to measure net income. This requires a matching of expenses with the revenues to which they relate. Unpaid expenses, that is, liabilities, that remain unpaid for substantial periods of time are not all of the same type. Some of these liabilities relate only to earning future income. For example, consider case 1 in my testimony. A company unconditionally commits this year to rent office space from a landlord for a year, 10 years from now and make rental payments in year 10. Admittedly this is a fairly contrived example.

But nevertheless the rental payment 10 years from now though unconditionally committed is not a cost attibutable to this year's income and no one is suggesting that any part of this future payment should be deducted currently.

Instead the payment should be deducted 10 years from now when the taxpayer has the use of the building. The administration's proposal reaches the correct result in this case but unfortunately only in this case. Other liabilities that remain unpaid for substantial periods of time are expenses of earning both current and future income.

Consider cases 2 and 3 in my testimony. In case 2, a public utility begins operating a nuclear powerplant and becomes liabile to decommission that plant at the end of its operating life.

In case 3, a mining company is bound by State statutes to restore land disturbed by surface mining.

The payments for decommissioning nuclear powerplants and for restoring land disturbed by surface mining differ significantly from the rental payments in my first case because the revenues, both current and future, from these projects cannot be earned without incurring the later expenses.

For example, to obtain the revenue from a nuclear powerplant the plant must be constructed. But no income can be earned unless that sucker is turned on, and once it has been turned on some type of decommissioning will be required at the end of its operating life.

Similarly, once land has been disturbed by surface mining, State and Federal environmental laws require mining companies to restore it. The cost of decommissioning and mining reclamation, therefore, are costs partly attributable to producing this year's income and if income is going to be properly measured, these costs should be spread over the operating life of the powerplant or the surface mine.

How should the costs be spread? If measuring net income is our standard, then the cost of decommissioning or restoring the land should be depreciated over the life of the investment. This is the same as what accountants call negative-salvage-value depreciation where the depreciable basis is equal to original cost less salvage value.

If the salvage value is negative, the depreciation taken over the life of the investment is greater than the original cost. It is equal to the original cost plus the negative-salvage value.

Now let me turn to another group of cases in which unpaid liabilities relate only to current income. Consider cases 4, 5, and 6 in my testimony. In case 4, a company estimates the amount of the future lump-sum payment it will have to make to settle a workers compensation-liability claim.

In five, a company agrees to settle a tort liability by making periodic payments over a number of years or possibly a lump-sum payment at some future date.

And in case 6, a company closes a plant and agrees to pay lifetime medical benefits for the workers.

In case 4, a worker is injured this year and the company estimates that it will have to pay $100,000 in a lump sum to settle the workers compensation liability. Assuming the $100,000 amount can be determined with reasonable accuracy, the company would, under current law, be allowed a deduction this year.

This is a reasonable result inasmuch as the liability for workers compensation is approriately a cost of producing this year's income. Moreover, uncontested-workers-compensation liabilities usually are paid soon after occurrence of the injury and, under the accrual method of accounting, deductions are allowed when the liabilities are accrued, not when actual payments are made.

Structured settlements involving periodic payments, case 5, however, do present a problem. Instead of discharging a $100,000 liability with a single cash payment a company may agree to make periodic payments totaling $200,000, say, $10,000 a year for 20 years.

The tax law now favors a periodic payment by allowing the full $200,000 to be deducted up front. Though the liability may be fixed

and the amount determined with reasonable accuracy, a current deduction of $200,000 does not result in proper matching of expenses with the revenues to which they relate. Indeed permitting a $200,000 deduction favors structured settlements over lump-sum payments.

Though the tax law should not discriminate against structured settlement, it need not favor them. To be neutral between lump-sum and structured settlements, the law must recognize that a structured settlement represents two separable transactions. The company could have discharged its liability with cash, and the cash could have been used by the injured person to purchase an annuity.

This suggests that in the case of a structured settlement the company's up-front deduction should be limited to what it would cost to purchase an annuity providing for the same periodic payments as agreed to in the structured settlement.

The company would then be treated as having purchased an annuity at a cost equal to the up-front deduction. Using the usual annuity rules, it would deduct the interest portion of the annuity payments when the payments are made to the injured worker.

To determine the cost of the annuity for a given stream of periodic payments, Treasury could prescribe appropriate discount factors. These factors presumably would be based on a before-tax discount rate because the company selling the annuity can deduct the interest portion of the annuity payments.

Case 6, where the company closes the plant and agrees to lifetime medical benefits, is similar to case 5 and I again suggest that the appropriate tax treatment is similar to what I suggested in case 5. The liability should be separated into two transactions.

In my testimony I go on and discuss a case 7 which relates to casualty insurance. I understand that the administration's proposal, however, does not apply to that and I will not in my oral presentation discuss that portion of my written statement.

The final portion of my testimony relates to the problem of reestimating future expenses when it becomes clear that the original estimate may be wrong. I have some suggestions here that would provide some workable procedures.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF EMIL M. SUNLEY, DIRECTOR OF TAX ANALYSIS, DELOITTE, HASKINS & SELLS

I am Emil M. Sunley, Director of Tax Analysis in the National Affairs Office of Deloitte, Haskins, & Sells, an international accounting firm. I welcome this opportunity to present testimony on the appropriate tax treatment of certain future payments or liabilities.

The issue before the Committee is the appropriate tax treatment for an accrual-method taxpayer of certain liabilities that remain unpaid for substantial periods of time. The Administration has recommended that no deduction should be allowed for tax purposes until economic performance has occurred; that is, until services are performed, property provided, the use of property occurs, and in the case of worker's compensation or a similar liability, until the liability is satisfied. In contrast, under the accrual method of accounting expenses are deductible when the all events test is met; that is, when the fact of the liability is established and its amount can be determined with reasonable accuracy.

My testimony today is not a legal analysis of whether or not a future payment meets the all events test for a current deduction under the accrual method of ac-

counting. Instead, I want to examine the economic reality of particular payments to see what would be a reasonable tax treatment for them. My framework is a simple one: If a tax is going to be imposed on income, it is necessary to measure net income. This requires matching expenses with the revenues to which they relate.

Consider the expenses arising in each of the following situations:

Case 1: A company unconditionally commits this year to rent office space from a landlord for a year, ten years from now, and to make rental payments in year ten.

Case 2: A public utility begins operating a nuclear power plant and becomes liable to decommission that plant at the end of its operating life.

Case 3: A mining company is bound by state statutes to restore land disturbed by surface mining.

Case 4: A company estimates the amount of the future lump sum payment it will have to make to settle a worker's compensation liability.

Case 5: A company agrees to settle a tort liability by making periodic payments over a number of years (or possibly a lump sum payment at some future date).

Case 6: A company closes a plant and agrees to pay lifetime medical benefits for workers.

Case 7. A casualty insurance company actuarially estimates the amount of payments it will make in the future to settle insurance claims arising from casualties incurred this year.

Liabilities that remain unpaid for substantial periods of time are not all of the same type. Some of these liabilities relate only to earning future income. For example, the rental payment ten years from now, though unconditionally committed (Case 1), is not a cost attributable to this year's income, and no one suggests that any part of this future payment should be deducted currently. Instead the payment should be deducted ten years from now when the taxpayer has the use of the building. The Administration proposal reaches the correct result in this case, but unfortunately, only in this case.

Other liabilities that remain unpaid for substantial periods of time are expenses of earning both current and future income (Cases 2 and 3). Examples of these expenses are investments with negative salvage value such as the expenses for mining reclamation and nuclear decommissioning. To achieve a proper matching of income and expense, these expenses should be spread over the life of the mining project or nuclear plant.

Still other unpaid liabilities relate only to current income (Cases 4, 5, and 6). For example, when a worker is injured, disability payments even if paid over a number of years should be matched to this year's income. A discounting of the future disability payments probably is appropriate.

Finally, the casualty insurance case, Case 7, is a case where one must look at the tax treatment of the insurance company and the insured to determine whether current law provides a workable procedure. It does.

INVESTMENTS WITH NEGATIVE SALVAGE VALUE—EXPENSES OF EARNING CURRENT AND FUTURE INCOME

The payments for decommissioniong nuclear power plants (Case 2) and for restoring land disturbed by surface mining (Case 3) differ significantly from the rental payments in Case 1 because the revenues from these projects cannot be earned without incurring the later expenses.[1] For example, to obtain the revenues from nuclear power plant, the plant must be constructed and then turned on. Once it has been turned on, some type of decommisioning will be required at the end of its operating life. Similarly, once land has been disturbed by surface mining, state and federal environmental laws require mining companies to restore it. The costs of decommissioning and mining reclamation, therefore, are costs partly attributable to producing this year's income. If income is going to be properly measured, these costs should be spread over the operating life of the power plant or surface mine.

How should these costs be spread? If measuring income is our standard, then the cost of decommissioning or restoring the land should be "depreciated" over the life of the investment. One might view this result as similar to what accountants call negative salvage value depreciation where the depreciable basis is equal to original cost less salvage value. If the salvage value is negative, the depreciation allowed

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[1] Nuclear power plants and surface mining are not the only examples of investments that require a significant outlay at the end. Other examples would include offshore oil rigs that must be dismantled and oil or gas pipelines that must be removed. The analysis here is also applicable to these other investments with significant negative salvage value.

over the life of the investment is greater than the original cost. It is equal to the original cost plus the negative salvage value.

The Appendix to this testimony demonstrates, as a theoretical matter, how the appropriate amount of depreciation for each year can be calculated. Formula approximations to these calculations could be acceptable. For example, the estimated expense might be amortized over the life of the project, though this pattern of deductions probably is more accelerated than that implied by economic depreciation. The amortization deduction could be based on the estimate of today's cost of restoring the land or decommissioning the nuclear plant. The estimated cost and the allowable deduction for amortization would be adjusted each year. Given inflation, this approach would result in lower deductions in earlier years than simply amortizing the expected expense at the end of the project. Other alternatives would be to spread the expected expense at the end of the project over the life of the project using the reverse of the sum-of-the-years digits method, the sinking fund method, or the unit of production method of depreciation. The last method would be similar to treating the final expense as an indirect cost added to inventory except that the deduction would be recorded when output is produced instead of when sold.

FUTURE PAYMENTS COMPENSATING CURRENT LOSSES—EXPENSES OF EARNING CURRENT INCOME

The next group of cases, Cases 4, 5, and 6, are situations where the payments in the future relate only to current income. The issue is whether these future payments should be discounted in determining the allowable tax deduction.

Consider Case 4. A worker is injured this year and the company estimates that it will have to pay $100,000 in a lump sum to settle a worker's compensation liability. Assuming the $100,000 amount can be determined with reasonable accuracy, the company would, under current law, be allowed a deduction this year. This is a reasonable result inasmuch as the liability for worker's compensation is appropriately a cost of producing this year's income. Moreover, uncontested worker's compensation liabilities usually are paid soon after the occurrence of the injury and, under the accrual method of accounting, deductions are allowed when the liabilities have accrued, not when the actual payments are made.

Structured settlements involving periodic payments, Case 5, do present a problem. Instead of discharging a $100,000 liability with a single cash payment, a company may agree to make periodic payments totaling $200,000; say, $10,000 a year for twenty years. The tax law now favors periodic payments by allowing the $200,000 to be deducted up front. Though the liability may be fixed and the amount determined with reasonable accuracy, a current deduction of $200,000 does not result in a proper matching of expenses with the revenues to which they relate. Indeed, permitting a $200,000 deduction favors structured settlements over lump sum payments.

Structured settlements involving periodic payments, however, can provide significant advantages from a public policy perspective. For example, if a lump sum payment is intended for future medical expenses, it may prove inadequate if the injured person outlives his life expectancy. Periodic payments for as long as the injured person remains alive would provide more adquate protection.

Though the tax law should not discriminate against structured settlements, it need not favor them. To be neutral between lump sum settlements and structured settlements, the law must recognize that a structured settlement represents two separate transactions. The company could have discharged its liability with cash, and the cash then could have been used by the injured person to purchase an annuity. This suggests that in the case of a structured settlement, the company's up front deduction should be limited to what it would cost to purchase an annuity providing for the same periodic payments as agreed to in the structured settlement.[2] The company would then be treated as having purchased an annuity at a cost equal to the up front deduction and, using the usual annuity rules, would deduct the interest portion of the "annuity" payments when payments are made to the injured worker. The result here is essentially the same as what would occur if the company is allowed to use reserve accounting for the future liability.

Case 6 where a company closes a plant and agrees to pay lifetime medical benefits for workers is similar to the structured settlement case. Companies using the accrual method of accounting can deduct the future payments even though some of the

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[2] To determine the cost of an annuity for a given stream of periodic payments, Treasury could prescribe appropriate discount factors. These discount factors presumably would be based on a before-tax discount rate because a company selling an annuity can deduct the interest portion of the annuity payments.

payments will not be made for a number of years. Some have even argued that this treatment gives companies and incentive to close plants.

Like the structured settlement case, the company could have discharged its liability to its former employees with a lump sum cash payment. Therefore, the company's up front tax deduction should be limited to the cost of purchasing an annuity for each worker. As payments are made, the company would deduct the interest portion of each payment.

Treating a series of payments as two separate transactions—a cash payment and an annuity—obviously increases tax complexity and should only be required where the future payments in cases like worker's compensation, a structured settlement, or a plant closing are expected to extend over three or more years.

The Administration's proposal, in contrast, would require every accrual-method taxpayer to determine for every liability that is unpaid at the end of the tax year whether actual economic performance has occurred. This would substantially increase the complexity of the accrual method of accounting which generally reflects obligations and expenses definitely incurred without regard to whether payment has been made.

CASUALTY INSURANCE

Case 7, the casualty insurance company case is fundamentally different from those cases involving negative salvage value. The Administration's proposal, it is understood, does not apply to insurance companies which are able to deduct the undiscounted estimate of their future claims. In testimony last June, however, the Treasury suggested that two alternative approaches should be considered. One method would be to defer the deduction until the insurance company actually pays the claim. Another would be to limit the deduction for unpaid losses to the discounted present value of the future payments.[3] Treasury apparently has reconsidered its June position and now recognizes that its analysis of the insurance case was flawed.

Casualty insurance in the simplest case involves the payment of a premium to cover losses incurred during the year. The actual payment of claims may be made over a period of years.[4] A reasonable tax treatment of casualty insurance must recognize that a loss has taken place during the year of the insurance coverage, and this is the fundamental difference between casualty insurance and the negative salvage value cases discussed already. For a proper matching of income and expense, the casualty loss should be deductible by someone that year.[5]

Consider first a world without insurance. In order to stay in business, companies would have to set prices for their products at levels sufficiently high to cover expected casualty losses. Some companies would have actual losses, and these losses would be deductible for tax purposes. When all companies are considered together, however, the amount charged customers (and included in taxable income) for expected casualties would just equal the amount deducted by companies that had actual casualty losses.

Now introduce casualty insurance but assume that the insurance companies pay their claims the same year the losses occur. Companies would have to set prices for their products sufficiently high to cover the premiums for casualty insurance. These premiums would be deductible for tax purposes but would be included in the taxable income of the insurance companies. Assuming all companies are in the same tax bracket, the tax savings from the deduction of the premium would just equal the tax paid by the insurance company on the premium income. The insurance company also would deduct the amount of claims paid which would just equal the amount of insured losses. The companies that had casualty losses would not include the insurance proceeds in income because the proceeds are just a reimbursement. Taking all companies together, it should be noted that the casualty losses are deducted for the year in which the loss occurs, just as in the world without insurance.

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[3] Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on June 13, 1983, before the Senate Finance Committee.

[4] Casualty insurance typically does not provide that the insured party is covered for loss in present value terms. However, a policy could be written providing that in the event of a loss, the amount paid would equal the amount of the loss plus interest from the date of the loss. In this situation one would need to worry about the appropriate tax treatment of the interest income.

[5] Note that a taxpayer who self-insures may not be able to deduct the loss currently under the rules of accrual accounting because the amount of the loss cannot yet be determined with reasonable accuracy. Also note that the discussion does not apply to structured settlements where the amounts paid exceed the amount of the loss.

Consider now the two Treasury alternatives, presented last June, for the world where insurance companies pay out casualty claims over several years. If the deduction is deferred until the insurance company actually pays the claim, there is a mismatch between when the loss is incurred and when someone, in this case the insurance company, is able to take a deduction for the loss. If instead the insurance company takes a deduction up front for the discounted present value of the future payment, the full amount of the loss is never deductible. The logical implication of the Treasury position would be to permit the insured, to the extent casualty losses ae deductible, to take a current deduction for the difference between the claim payment expected in the future and the present value of that claim.[6]

These present value calculations could lead to significant IRS/taxpayer disputes. Current law which permits a current deduction by the insurance company for the expected claim probably is a workable procedure. Insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company and no part of the insured loss is deductible by the insured even though the claim is paid after a lapse of several years.

REESTIMATES

A major argument advanced by the Administration for its proposal to allow no deduction until the liability for mining reclamation or nuclear decommissioning is a current one is the difficulty in accurately estimating today the amount that will be paid five to thirty to even fifty years from now. Under current law a liability does not accrue unless it can be determined with reasonable accuracy. This is essentially a question of fact.

The current rules for accrual accounting provide for a correction of estimated amounts, but the correction only occurs once the exact amount is subsequently determined. This may not provide adequate protection for the taxpayer or the Treasury: If the original estimate is too low, the taxpayer is disadvantaged. If it is too high, the Treasury loses.

Consequently, if Congress were to adopt a rule permitting taxpayers to spread estimated future payments for mining reclamation, nuclear decommissioning, and similar items, over the life of the project, Congress could require that these future costs be periodically re-estimated every one to three years. The allowable "depreciation" or amortization for the current and future years then would be correspondingly adjusted. As long as the original or prior estimate was made with reasonable accuracy, any correction or adjustment of the estimate would not be related back to the prior years.

Should the estimate of a future cost or payment include an inflation factor; that is, should the estimate be in the nominal dollars of the future year or should the estimate for today's cost of decommissioning the plant or reclaiming the land? The Appendix suggests that, as a theoretical matter, the estimate should include the inflation factor. However, again, as a theoretical matter, the pattern of deductions probably should be less accelerated than that permitted by amortization or straight-line depreciation. One way of achieving this pattern of deductions and avoiding taxpayer/IRS disputes over future rates of inflation would be to permit amortization of this year's cost of reclaiming the land or decommissioning a plant. The estimated cost then would be adjusted annually for the change in the price level, and this adjustment would affect only current and future deductions and would not affect the deductions allowed in the prior years.

Admittedly, the uncertainties as to the exact amount of the future payments is a problem. But this problem should not obscure the fact that when revenues from current projects cannot be earned without incurring later expenses, these expenses should be spread over the operating life of the project. Otherwise, expenses will not be matched with the revenues to which they relate and net income will not be properly measured.

APPENDIX.—INVESTMENTS WITH NEGATIVE SALVAGE VALUE

Investments in surface mining, nuclear power plants, or offshore oil rigs have significant negative salvage value; that is, the cost paid at the end for reclaiming, decommissioning, or dismantling exceed the value of the salvagable materials. The positive cash flows from these investments cannot be earned without incurring the

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[6] Under the IRS regulations (§ 1.165–1(d)(2)), no portion of a loss with respect to which a reimbursement may be received is sustained until it can be determined with reasonable certainty whether or not such reimbursement will be received. Taxpayers are not allowed to deduct the loss when incurred and then later include the insurance proceeds in income.

negative outlay at the end. To examine the appropriateness of alternative tax treatments of the final outlay, consider a $3,000 investment that yields positive cash flow of $1,000 per year for five years and then requires "dismantling." This investment in a world without taxes would have an internal rate of return of 10 percent as shown below.

TABLE 1

Year	Cash flow	Present value (r=0.10)
1	$1,000	$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
6	−1,401	−790.82
Total		3,000.00

The issue then is what is the appropriate tax treatment of the final outlay of $1,401? Treasury has argued that it should be expensed in the year paid. Here I am suggesting that a proper matching of oncome and expense requires that the final outlay be "depreciated" over the life of the investment. Tax depreciation (or capital recovery) is neutral, a Paul Samuleson has shown, if (and only if) the true loss of economic value is permitted as a tax deductible depreciation expense.[7] Moreover, if economic depreciation is allowed, the effective tax rate is equal to the nominal tax rate.

Economic depreciation can be determined by discounting for each year the remaining before-tax cash flow to the beginning of that year using the before-tax discount rate.[8] Econimic depreciation is then equal to the change in the present value of the future cash flow.

The interpretation of the third column of Table 2 is fairly straight forward. At the end of year 0, someone would pay $3,000 for this investment. At the end of year 1, once the first $1,000 of positive cash flow has been realized, someone would pay only $2,299.95 for the future cash flow. At the end of year 4, the value of the future cash flow has become negative. That is, the owner of the investment would have to pay someone to take the investment of his hands. the reason for this, of course, is that the present value of the future detriment (the $1,401) is greater than the present value of the future positive cash flow—the $1,000 at the end of year 5.

TABLE 2

Year	Cash flow	Present value of future cash flow discounted to beginning of year (r=0.10)	Depreciation[1]
0	−$3,000	$3,000.00	
1	1,000	2,299.95	$700.05
2	1,000	1,529.95	770.00
3	1,000	682.95	847.00
4	1,000	−248.77	931.72
5	1,000	−1,273.64	1,024.87
6	−1,401	−1,401.00	127.36
Total			4,401.00

[1] Equal to the change in the present value of the future cash flow.

[7] Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," *Journal of Political Economy* (December 1964).

[8] It can also be obtained by discounting the after-tax cash flow by the after-tax discount rate.

It should be noted in the last column of Table 2 that economic depreciation permits $4,401 of capital recovery over the life of the project. Put another way, economic depreciation spreads the $3,000 initial investment plus the $1,401 final outlay over the life of the investment.

Table 3 demonstrates that if economic depreciation, as calculated in Table 2, is allowed, the effective tax rate is just equal to the nominal tax rate. For purposes of Table 3, a 50 percent tax rate is assumed. The after-tax rate of return is now 5 percent, which is just half of the 10 percent before-tax rate of return.

TABLE 3

Year	Before-tax cash flow	Economic depreciation [1]	After-tax cash flow [2]	Present value (r = 0.05)
1	$1,000	$700.05	$850.02	$809.54
2	1,000	770.00	885.00	802.72
3	1,000	847.00	923.50	797.77
4	1,000	931.72	965.86	794.26
5	1,000	1,024.87	1,012.44	793.26
6		127.36	63.68	47.52
7	−1,401		[3]	−1,045.43
Total				[4] 3,000.00

[1] Equal to the change in the present value of the future after-tax cash flow.
[2] Equal to $(1-m)R_t + mD_t$ where m is the marginal tax rate, R_t is the before-tax cash flow, and D_t is economic depreciation which is also the depreciation allowed for tax purposes.
[3] Equal to the persent value of $1,401 discounted at 5 percent. The final outlay has no tax effect inasmuch as it has been depreciated over the life of the investment.
[4] The present value of the cash-flow is just equal to the initial investment.

That a future outlay for mining reclamation or nuclear decommissioning should be written off over the life of the project may become clearer if one compares two investment projects—one a normal investment where the investment outlay is made only at the beginning of a project and the other an investment where a significant outlay is made at the end of the project.

For convenience, the two investment projects may be considered an underground mine and a surface mine. Both projects yield a positive cash flow of $1,000 per year for five years. The underground mine requires an initial investment of $3,790.80, but requires no outlay at the end of the project. The surface mine requires an initial investment of $3,000 and final mining reclamation expenses of $1,401, essentially the example used in Tables 1, 2, and 3. Both investments have a 10 percent before-tax rate of return.

Given these two investment projects, a mining company would be indifferent between them in a world without taxes inasmuch as they both would yield a 10 percent rate of return. Given that these two investments have the same before-tax rate of return, the tax law should not favor one over the other.

If tax depreciation is equal to economic depreciation then the after-tax rate of return for both projects will be the same and the effective tax rate will be equal to the nominal tax rate. Table 4 demonstrates that the underground mine example has a 10 percent before-tax rate of return. Table 5 derives economic depreciation for the underground mine example. It should be noted that the pattern of economic depreciation is the same for the underground mine as for the surface mine. In both cases the total investment—$3,790.80 for the underground mine and $4,401 for the surface mine—is written off over the life of the project. Finally, Table 6 shows that with tax depreciation equal to economic depreciation, the after-tax rate of return for the underground mine is equal to 5 percent, the same as the after-tax rate of return for the surface mine, as shown in Table 3.

What do we conclude from all this? A proper matching of income and expense requires that the costs of mining reclamation (or nuclear decommissioning or oil rig

dismantling) be written off over the life of the project. Delaying the deduction until the expense is actually paid, as proposed by the Administration, does not produce the correct result.

TABLE 4

Year	Cash flow	Present value (r = 0.10)
1	$1,000	$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
Total		3,790,80

TABLE 5

Year	Cash flow	Present value of future cash flow discounted to beginning of year (r = 0.10)	Depreciation [1]
0	$3,790,80	$3,790,80	
1	1,000,00	3,169.88	$620.92
2	1,000,00	2,486.86	683.02
3	1,000,00	1,735.54	751.32
4	1,000,00	909.09	826.45
5	1,000,00	0.00	909.09
Total			3,790.80

[1] Equal to the change in the present value of the future cash flow.

TABLE 6

Year	Before-tax cash flow	Economic depreciation [1]	After-tax cash flow [2]	Present value (r = 0.10)
1	$1,000,00	$620.92	$810.46	$771.87
2	1,000.00	683.02	841.51	763.27
3	1,000.00	751.32	875.66	756.45
4	1,000.00	826.45	913.22	751.32
5	1,000.00	909.09	954.54	747.89
Total				[3] 3,790.80

[1] Equal to the change in the present value of the future after-tax cash flow.
[2] Equal to $(1-m)\ R_t + mD_t$ where m is the marginal tax rate, R_t is the before-tax cash flow, and D_t is economic depreciation which is also the depreciation allowed for tax purposes.
[3] The present value of the cash-flow is just equal to tne initial investment.

Chairman RANGEL. Thank you.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel. Mr. Lewis, you said we should consider the flip side of the issue; that is, when you accrue income before receiving the cash, the Joint Tax Committee and Treasury have, on that issue, asked for examples from the industry. We have really found no such situations. Can you give us some examples of what you are referring to?

Mr. LEWIS. Yes. Often services are rendered and services are not billed for until substantial time later and payment is not received until a substantial time after that.

Under the accrual method of accounting, the taxpayer must reflect that income when the services are rendered, not at the later time when the payment is received. It seems to me that is the flip side of the case the Treasury is talking about in which the expense under accrual accounting would be taken today but the payment will not be made until later.

It seems to me they are just the mirror image of each other.

Mr. DUNCAN. Thank you.

Mr. Sunley, I gather you apparently are saying that you think Treasury's approach is essentially correct in the case of ordinary and necessary business expenses but not correct for capital expenditures; is that correct?

Mr. SUNLEY. That is true. In fact in their testimony on Wednesday they cited an example of a partnership which was committed to pay for R&D expenses for R&D which was going to be performed 10 years in the future. I don't think anyone would reach the conclusion that a future expense which provides a future benefit should be deductible at this time.

Mr. DUNCAN. How would you treat situations such as an obligation to pay rent; nuclear plant decommissioning costs; mining reclamation expenses; workers compensation liabilities; periodic payments for possible future liabilities; and for lawsuits and payments for benefits related to a closing of a plant? How would you treat those situations?

Mr. SUNLEY. I think you have to look at each example, Mr. Duncan, to decide what in economic terms is really going on. If you have——

Mr. DUNCAN. Let's start there with a mining and reclamation situation.

Mr. SUNLEY. Mining reclamation or nuclear decommissioning are examples of future expenses that properly relate to earning current and future income. I would suggest that those future expenses should be spread over the life of the project.

Mr. DUNCAN. And the other instances?

Mr. SUNLEY. The others you mentioned——

Mr. DUNCAN. Pay rent, workers compensation——

Mr. SUNLEY. Workers compensation, for example, is a situation where the worker was injured this year. You are committed to pay an expense in the future; that expense is properly attributable to producing this year's income and it should be deducted this year.

Now when you get to a situation like the structured settlement, which Mr. Keen also described, where instead of satisfying a liability with $100,000 cash payment you agree to pay $200,000 over a period of time, it is really inappropriate to deduct the full $200,000 now. It seems to me you have to disentangle that and say the company could have satisfied its liability with a cash payment of $100,000 and purchased an annuity for the worker.

So you would give him a deduction for cost of the annuity, and then as they actually make payments each year you would treat those payments the same under the usual annuity rules. I think

you get a reasonable answer that reflects what is really going on in this situation.

Mr. DUNCAN. But you don't get the cost of the annuity at one time?

Mr. SUNLEY. The cost of the annuity would be deducted this year. That is what it would cost you to pay that worker a cash settlement this year. He was injured this year, producing this year's income. So that is a proper matching of income and expense.

Mr. DUNCAN. Thank you very much.

Chairman RANGEL. Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman.

Mr. Sunley, have you ever taken a look at that nuclear decommissioning bill that I have?

Mr. SUNLEY. I am familiar with it, Mr. Gibbons.

Mr. GIBBONS. Am I on the right track?

Mr. SUNLEY. You are on the right track in that the expenses really need to be spread over the life of the project. That is the correct solution. It is the conceptually correct answer. It seems that Treasury's main objection is the problem of estimating that expense and it seems to me there are a number of solutions to that problem. You can estimate what it would cost to do it today and spread that estimate over the life of the project and then, say several years from now, after we have had inflation, reestimate it and spread that additional cost over the remaining life of the project.

There are ways to handle it that would allow you to reach, it would seem to me, a reasonable matching of revenues and expenses. It is just very clear that when it comes time to decommission the plant that is not a cost of earning that year's income.

Mr. GIBBONS. That is right.

Mr. SUNLEY. It is the current——

Mr. GIBBONS. It was the part of every year's income.

Mr. SUNLEY. Yes.

Mr. GIBBONS. To do justice between ratepayers, taxpayers and everything else you ought to do it every year rather than waiting to bunch it up at the end, isn't that correct?

Mr. SUNLEY. That is true.

Mr. GIBBONS. Why is Treasury having trouble with that, do you think? I have listened to them. They didn't teach this stuff when I was in college, and I haven't caught on yet. What is going on?

Mr. SUNLEY. To some extent Treasury incorrectly analyzed some of the underlying economics of this thing and, in the testimony with respect to mining reclamation that they gave last year, they asserted that you always get the right result if you deduct the amount when you pay it. That is an incorrect analysis of the basic economic facts of what is going on.

Mr. GIBBONS. Could we divide it up into year by year sections? Some of us are not privileged to live in every one of those years.

Mr. SUNLEY. I tried to show in a rather complex appendix to my testimony, Mr. Gibbons, that if you had two investments, one of which was say a normal investment—all the capital investment occurs at the beginning and there is cash flow for a number of years—and then you had another investment which had some negative salvage value, significant negative salvage value, and the two investments earn the same return before tax, you would want to

design a tax rule it seems to me that does not discriminate or favor one technology over the other.

My first investment may represent an underground mine; my second example may represent a surface mine. I don't see any reason why the tax law should favor one technology over the other. What my appendix demonstrates, is that in both cases you would want to spread capital cost—whether at the beginning of the project or at the end of the project—over the life of the project.

Mr. GIBBONS. Thank you.

Mr. SUNLEY. I think it is interesting to note that—other than at one moment when Mr. Pearlman asserted that the approach that they were recommending reaches the right economic result—in general they were not saying that today. They did not say what they said last year on the mining-decommissioning testimony—that deducting the expense when paid is always the right result. Instead they are really arguing that a deduction out there is worth less than a deduction now, we would have to discount, discounting is complicated, it costs Treasury money to give the deduction now, let's have the deduction out there—but they never really built the case for you why deducting it then is the economic appropriate result.

Mr. GIBBONS. That helps me, restores my confidence in the system. Thank you.

Mr. SUNLEY. Thank you.

Chairman RANGEL. I think the Treasury has shifted their position as relates to mining and nuclear questions. I guess it is just some question of trying to determine which formula they believe is one they can best work with.

Mr. SUNLEY. Mr. Chairman, I found that it was quite amusing on the Treasury testimony, they have a denial at the top of it that "the time constraints have not permitted the OMB to advise on the relationship of the statement to the program of the President."

Their statement is indeed a fair statement of what the President proposed in their budget, but it is true when you were questioning Mr. Pearlman they were backing away from that pretty fast and beginning to recognize that some other solution in the mining reclamation and nuclear decommissioning not only probably is appropriate but is needed.

They have not cleared that with OMB yet, I suppose.

Chairman RANGEL. You have all been of great help to this committee as you have been in the past. Obviously we are confronted with a rather complex problem, at least we understand the problem but we have some difficulty in reaching an equitable solution.

Mr. Aidinoff?

Mr. AIDINOFF. I would like to add one point. If one assumes that the present value of a $100 million deduction that is going to be given 15 years from now is, say, $25 million, it does not follow that if you give the deduction up front the sole deduction should be $25 million. $25 million is only the right deduction if the Treasury is correct in its statement that you are not entitled to the deduction until 15 years hence.

I think that you have to be very careful in analyzing the various proposals for giving a present value deduction in not really depriv-

ing the taxpayer of what is his fair deduction over the full period of time.

Chairman RANGEL. What I am asking is, assuming there would be no dispute as to what would be the fair cost of the deduction to the taxpayer, you don't have any problem that that amount should be adjusted and taken into consideration at the time of the deduction, do you?

Mr. AIDINOFF. I have no difficulty with a concept that the full $100 million should be deducted over the full 15-year period. But not necessarily on a straight line basis, Mr. Chairman.

Chairman RANGEL. Regardless of whether the final amount is accurate or not, that could be adjusted.

Mr. AIDINOFF. I think the problem of adjustment has nothing to do with the issue at all. I regard that as a pure red herring. We adjust all the time. Salvage values, for example, get adjusted in certain contexts. I am a lawyer, but I can tell you that the whole science and art of accounting is when to make these various adjustments. Internal Revenue Service auditors do it all the time.

If there is going to be a change in expected costs down or upward, the appropriate adjustment can be made without any difficulty at all.

Chairman RANGEL. We do hope you would stick with us as we wrestle with this problem. And I don't know what your availability would be, but it would be very helpful rather than waiting until we come up with a legislative conclusion for your review if you could first assist us in trying to work out some formula.

We certainly appreciate the fact that we have been able to call on you from time to time as we face these complex problems, and we are especially grateful that you took time out to share your views with us today. Thank you very much.

Chairman RANGEL. The next panel will be called out of order: The National Association of Regulatory Utility Commissioners, Joseph Cresse, commissioner of the Florida Public Service Commission; the National Association of State Utility Consumer Advocates, Steven Hamm, president; the Critical Mass Energy Project, Sally Hindman; and Battelle Memorial Institute, Dr. Ambrose, vice president and director.

Mr. Gibbons, you have the floor.

Mr. GIBBONS. Mr. Chairman, I would like to introduce one of the panelists, Mr. Joseph Cresse. Mr. Cresse is the chairman of the Florida Public Utilities Commission. He has had a distinguished background in public service and in the accounting field. He is recognized nationwide as being an authority on public utility regulation.

He is speaking today in behalf of the National Association of Regulatory Utility Commissioners, which I assume is their national organization. So he is representing 50-plus regulators.

Is that right, Mr. Cresse?

Mr. CRESSE. Yes, sir.

Mr. GIBBONS. That is an impressive group to represent.

We have had representatives of your association before, and I realize you are all in a tough position having to set rates in 50-plus jurisdictions throughout the United States. We are glad to have you here.

STATEMENT OF JOSEPH P. CRESSE, COMMISSIONER, FLORIDA PUBLIC SERVICE COMMISSION, REPRESENTING THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. CRESSE. Thank you, Mr. Gibbons.

Let me just be very brief, Mr. Chairman, if I might, because I think Congressman Gibbons kind of summarized for me what I was going to say.

I think that there is no question that everybody agrees that costs will be incurred to decommission nuclearpower plants. The disagreement seems to be when that will occur and how much it will cost.

Currently, none of the money that we assess to set aside for those decommissioning costs are treated by the IRS as current expense. Therefore, those regulators who are in fact acting what I call responsibly to cover those costs from current ratepayers who are benefiting from nuclear power generation, are in fact having to pay a tax on an expense; therefore, they are paying more than they would be obligated to pay or should be paying since this should be treated as a current operating expense.

Regulatory bodies should and must under the laws of this land allow utilities to recover prudently incurred costs—not all, but prudently incurred costs. In my opinion, failure of the Congress or IRS to recognize the amounts collected from ratepayers as a current expense encourages regulators to not allow these costs, either. Thus, failure of Congress and the IRS to recognize these expenses currently encourages State regulators to practice fiscal irresponsibility by placing these costs on future generations.

I do not think that that is what you want to do. IRS seems to be concerned that too much will be accrued and therefore something will happen; something bad will happen. I suggest when that gets to be the only issue, when we agree on the principle of recovery of costs when costs should be recovered, that certainly assistance from the Department of Energy or the Nuclear Regulatory Commission, whoever is charged with the responsibility for nuclear safety, could probably give you and the IRS good estimates of what it will cost to decommission these plants.

The estimates we use are that many of them will cost as much to decommission as they cost to build them in the first place. I would hope we could address this issue in such a way that current expenses for decommissioning would be treated as a current expense and you would not encourage the regulators throughout the country to mortgage the future of this country. That is, too much of that is going on historically, and I hope you would give us the opportunity to treat it in the manner it should be treated.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF JOSEPH CREESE, COMMISSIONER, FLORIDA PUBLIC SERVICE COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF PUBLIC SERVICE UTILITY COMMISSIONERS

Mr. Chairman and members of the subcommittee, my name is Joseph P. Cresse and I am a commissioner with the Florida Public Service Commission. I am testifying today on behalf of the National Association of Regulatory Utility Commissioners, commonly referred to as the "NARUC". Accompanying me today is Linda Kent, NARUC Director of Congressional Relations.

The NARUC is a quasi-govermental, nonprofit organization founded in 1889. Within our membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands which are engaged in the regulation of utilities and carriers. Our chief objective is to serve the consumer interest by seeking to improve the quality and effectiveness of government regulation in America.

We appreciate your invitation to testify on the tax treatment of nuclear decommissioning costs. The Florida Public Service Commission and the NARUC endorse House Bill 2820 which was introduced by the Honorable Sam Gibbons to resolve a problem which is creating an extra expense for citizens served by nuclear power plants.

The bill is designed to amend Section 162 of the Internal Revenue Code of 1954 so that the amounts paid by customers to provide for future nuclear decommissioning costs will be recognized as a current expense for tax purposes.

The Internal Revenue Service (IRS) currently takes the psoition that the costs of decommissioning are not tax deductible expenses until they are actually incurred and monies are expended. The effect of that position is that monies that are collected from ratepayers during the life of the plant to pay for the expense that will come when the plant is no longer useful will be taxed as regular income.

Unless we are willing to ignore the real cost that is coming and hope that the ratepayers of that period will be able to pay for the cost of a nuclear plant which will provide them no benefit, we logically must recognize the reality of those future costs and allocate them to ratepayers who are receiving the benefits of lower cost electricity produced from those nuclear plants.

The policy of IRS, however, is a disincentive to face those facts. The current IRS policy, which creates a mismatch between the taxes to be paid and the expenses which would offset those taxes, creates cost to current ratepayers in addition to the actual decommissioning requirements. Since utilities are required to pay the taxes, ratepayers are required to pay more so that tax dollars can be sent to IRS until they are credited against taxes payable in the year or years after the decommissioning expense occurs.

When you calculate the costs of the alternatives, the simple fact is that with the compounding effect of the earning power of the dollars that ratepayers pay in through the years, this bill would allow us to charge ratepayers fewer total dollars without increasing the total amount of the tax deduction earned for decommissioning expense.

Under the present IRS filing, it is costing ratepayers of Florida's nuclear utilities $24,700,000 per yea for decommissioning expense. Over the life of the five nuclear plants in Florida, ratepayers will pay a total of $702,598,000 so that decommissioning funds will be there when decommissioning costs come due. There is no dispute that costs will be incurred in dismantling these plants; the great uncertainty is how much it will cost. We have, however, faced the problem and have begun collecting the amounts necessay each year according to the best estimates available.

This bill would allow us to continue funding those costs at a total saving to ratepayers of $255,620,000. Instead of the $24,700,000 we are now charging ratepayers, we would only have to charge ratepayers $15,830,000 per year—a savings of $8,870,000 per year on their electric bills. This can be accomplished simply by matching the tax effect of the decommissioning expense with the actual payment of that expense by ratepayers.

We believe today's ratepayers should be required to provide for those costs on a pay-as-you-go basis without leaving that burden to be faced by future generations. And, we believe they should be allowed to do so without having to pay the additional cost year by year of the tax dollars which the IRS holds until decommissioning actually occurs.

Millions of Floridians receive the benefits of nuclear power and I believe most of them would recognize the basic fairness of paying their share of the cost of decommissioning. Without understanding the complexities and differences of the federal tax code and regulatory requirements, however, I doubt if they would ever understand why they would also have to pay the expense of income taxes on those funds.

The simple facts are that the current system is inequitable and unjust, and requires Congressional action, unless Congress wants to encourage regulators to leave this cost for future generations.

Despite the disincentive of the additional tax expense, we felt it was important to fully fund a decommissioning reserve in Florida. I do not know how many other states have taken the steps to assure that decommission funds will be available when they are needed, but all should be encouraged to do so.

Passage of HB 2820 will help solve the tax problem associated with the future decommissioning of nuclear plants, will reduce the likelihood that funds for decommissioning will be inadequate, and will remove an unnecessary tax cost for ratepayers and regulatory bodies facing the problem and collecting the cost on a current basis. This bill will recognize these costs and the funds to cover these costs are collected from the ratepayers who should pay. The decommissioning cost is certain. We would be wrong not to collect these funds while the plants are operating, and it is wrong to tax these receipts and discourage, rather than encourage, efforts to assure that the funds will be available when that time comes.

Thank you for your consideration in this matter.

SUMMARY OF NARUC TESTIMONY

The NARUC endorses 2820, a bill to amend Section 162 of the Internal Revenue Code of 1954 so that amounts paid by customers to provide for future nuclear decommissioning costs will be recognized as a current expense for tax purposes.

Under current IRS policy, decommissioning costs are not tax deductible expenses until actually incurred so monies collected from ratepayers during the life of the plant to pay those costs is taxed as regular income.

The current IRS policy creates a disincentive for charging decommissioning costs to the ratepayers presently receiving the benefits of nuclear plants and creates a greater cost to ratepayers to cover the tax which the IRS will hold until decommissioning occurs.

H.R. 2820 would permit a substantial savings on ratepayers' electric bills by matching the tax effect of the decommissioning expense with the actual payment of that expense by ratepayers.

Chairman RANGEL. Thank you.

Mr. Hamm.

STATEMENT OF STEVEN W. HAMM, PRESIDENT, NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, AND PUBLIC ADVOCATE FOR THE STATE OF SOUTH CAROLINA

Mr. HAMM. Thank you, Mr. Chairman.

On behalf of the National Association of Consumer Utility Advocates, I would like to support the comments of Commissioner Cresse and raise two other issues. I believe Mr. Gibbons outlined some of the legitimate concerns his bill addresses, and I would like to indicate that our organization supports those positions but suggest that an additional situation deserves consideration by your subcommittee.

We support the concept of current deduction for the expenses associated with decommissioning. There is no doubt that the current revenues and the economic wasting of these plants are going on now. We need to recognize future costs at this point. Decommissioning is, in fact, a known event, and it is important for Congress to assist the State regulatory commissioners, such as Mr. Cresse, in recognizing this situation in the current rates paid by ratepayers.

The issue that the National Association of Consumer Utility Advocates is concerned about is the question of the use of the funds during the interim period, funds that may be collected for decommissioning, but those funds may not need be disbursed for 25 to 40 years. Our association is concerned that any legislation that may be ultimately adopted by this subcommittee, and ultimately the Congress, provide the needed flexibility to State utility commissions to insure that if the State utility commission determines that separate segregation of the funds is necessary to protect ratepayers, that such action will not threaten the tax deductibility issue that Mr. Gibbons attempts to address in his bill.

Without the clear statement by Congress in any legislation that in fact State action by the State regulatory commissions will not be construed to interfere with tax deductibility, we are concerned that there will be arguments made before State commissions in the course of a rate proceeding that State commissions are in fact precluded from limiting and segregating those funds to protect ratepayers on the basis that the IRS would conclude that the tax deductibility would no longer exist.

We believe that that issue can be addressed in this legislation by making it clear that the ultimate determination of the use of those funds between the times they are now collected and the many years from now when they will be disbursed remain solely in the hands of the State regulators, since they are ultimately responsible for determining the current rates that ratepayers must pay for services.

Recognizing the time, I believe that adequately describes our concerns. We support the concept. We believe that additional protection should be contained in the bill, and we believe basically that that issue is—give the State regulatory authorities the ability to consider arguments in their rate proceedings that insure the protection of these funds.

In the State of South Carolina, a recent electric utility was placed into service, its only nuclear-generating facility, and it is predicting decommissioning costs 30 years from now in the range of $100 million. Obviously, any funds collected for the purpose of that decommissioning need to have assurances that as those dollars are paid, they are in fact available when that event happens so there isn't another question then to burden the ratepayers at that time 30 years from now who have no benefits from the plant, and say now is the time for you to fork up $100 million because we forgot to insure the availability of those funds, and we are now going to need to collect it a second time.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF STEVEN W. HAMM, PRESIDENT, NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES

I. INTRODUCTION

The National Association of State Utility Consumer Advocates (NASUCA) is composed of officials in 32 States that are directed by law to represent the interest of consumers of regulated public utility services before state utility commissions.

As a result of their direct involvement in literally billions of dollars worth of utility rates cases throughout the United States, NASUCA purposes as these amounts are restricted to decommissioning welcomes this opportunity to express its views to this Subcommittee on the treatment of funds collected for nuclear decommissioning costs in order that all sides of this very important issue are considered prior to final implementation of any piece of legislation.

II. POSITION OF NASUCA

As the President of the National Association of State Utility Consumer Advocates, I would like to comment briefly on nuclear decommission tax mechanisms and on HR 2820, which deals with the tax treatment of funds collected by electric utilities for decommissioning nuclear generating plants.

A large number of major electric rate increase cases have been filed across the United States due to the completion of major nuclear generating facilities. It would be a bitter pill to swallow if ratepayers not only had to pay substantially higher

rates now to cover the tremendous costs associated with the construction of those facilities and later find out that the funds that they have been providing for decommissioning over the years were not available at the time needed.

This Committee, in its consideration of HR 2820, is in a position to insure that the availability of funds collected for nuclear decommissioning purposes is not an additional worry that need be borne by the nation's electric utility ratepayers. Considering the tremendous impact that federal taxes have on utility expenses, NASUCA supports giving federal tax-free treatment to dollars a utility collects for decommissioning members have had an opportunity to review financial data and all other aspects of the electric utility industry. NASUCA use and are maintained independently of utility general funds in such a manner that will insure that the amounts collected and their associated earnings will be available to cover the costs of decommissioning. NASUCA is not recommending a particular type of decommissioning or method of funding decommissioning.

Any legislation must balance the various interests of the parties that may be affected by the provisions of that legislation. Considering the rapidly rising costs of electric power in the United States and the public's concern over the economic viability of nuclear power and safety issues, it is important to consider the public's perception regarding the availability of the dollars they provide to an electric utility in their current rates to pay for future decommissioning costs. The nuclear power industry in the United States is not so healthy in the minds of its ratepayers that it can afford to cause further concerns by requesting an additional source of cost-free capital. This capital might then be utilized to make construction decisions that would not ordinarily withstand careful economic scrutiny. Congress can assure that funds collected for nuclear decommissioning purposes are to be used only for decommissioning purposes. NASUCA is opposed to any federal action mandating that nuclear decommissioning funds generated by ratepayers in their current rates are to be utilized as a large source of cost-free funds for our nation's electric utilities. Congress, through the tax laws, has provided electric utilities with a mechanism to collect and retain tax funds for signficiant periods of time before they are ultimately forwarded to the federal treasury. NASUCA is opposed to creating an additional mechanism that would create another major source of such cost-free funds, especially in light of large generating capacity reserve margins that now exist in many parts of the United States.[1]

The proposed legislation deals with the issue of collecting funds to decommission nuclear generating stations—a process that will not generally take place for the next 20–30 years. As a Nuclear Regulating Commission draft report notes, no matter what the current financial health of a utility is, financial solvency of any particular enterprise or even the structure of the electric utility industry cannot be projected with confidence so far in the future.[2] Thus it is essential in any legislative considerations to insure that the funds collected from current ratepayers are, in fact, available to meet decommissioning costs that will ultimately be incurred in the future.

If legislation is enacted that does not insure the availability of funds necessary to decommission a nuclear generating station at the end of its service life, it will only serve to create additional concerns for the nation's electric utility ratepayers. These ratepayers are currently being required to provide the funds for decommissioning in their electric rates. Given the economic questions concerning the nuclear industry in the United States, it is important to demonstrate to ratepayers that legislators take all the steps necessary to protect adequately the dollars these ratepayers they are being asked to pay today for decommissionings that will be undertaken in the future.

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[1] See Testimony of Andrew Varley, Chairman of the Iowa State Commission and Chairman of the NARUC Committee on Electricity, before the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce, February 7, 1984. Commissioner Varley noted that the electric utility industry has reserve margins in the range of 35–40 percent with 1983 electricity generation statistics running only slightly ahead of 1981 levels. Considering the tremendous reserve margins that exist at this time and the large number of abandoned generating facilities in the United States, it is important to approach with caution any proposal that the utility industry might advance that it needs additional sources of cost-free funds for construction purposes.

[2] "Assuring the Availability of Funds for Decommissioning Nuclear Facilities" U.S. Nuclear Regulatory Commission, NUREG–0854, Rev. 3, p. 3.

II. NASUCA POSITION SUMMARY

1. It is vital to insure that any legislation passed by Congress: (a) allows state utility commissions to make the final decisions about the ratemaking treatment of such funds and (b) clarifies that state utility commissions have the final authority to determine whether or not it is appropriate for utilities to have unlimited use of these funds between the time they are collected from ratepayers and the time they are ultimately spent for decommissioning purposes. No legislation should be enacted that would threaten the tax-free treatment of dollars collected for decommissioning purposes, if state utility commissions act to protect ratepayers by restricting utility use of such funds prior to the time a nuclear plant is decommissioned.

2. NASUCA supports the legislative intent in HR 2820 to the extent that it attempts to provide tax-free status to the dollars collected for nuclear decommissioning purposes in order to reduce the final cost to ratepayers. Congress must insure that the public is adequately protected until many years down the road when each and every nuclear generating facility must ultimately be decommissioned.

3. NASUCA does not support HR 2820 as presently drafted, because it provides no safeguards to ensure that funds collected for nuclear decommissioning purposes will in fact be available when decommissioning is scheduled to occur.

4. Members of NASUCA are not insisting that any federal legislation mandates a particular form or method of funding decommissioning.

Chairman RANGEL. Does that put the State regulators in the position of being trustees for the funds collected towards the decommissioning?

Mr. HAMM. What it does, your honor, in terms of the State regulatory authorities throughout the United States, they are in somewhat a trustee position now for the public in terms of looking after their interests. They have been directed by their States to evaluate the financial conditions of these utilities. But we are concerned that if the legislation doesn't make it clear that the State regulatory authorities can in fact require utilities to segregate the funds, not have unlimited use of the funds during the period of time, that might threaten the availability of the funds.

Chairman RANGEL. Would they be trustees with a fiduciary relationship to be sure the funds are available?

Mr. HAMM. Yes, sir.

Chairman RANGEL. Thank you.

STATEMENT OF TOMMY W. AMBROSE, PH.D., VICE PRESIDENT AND DIRECTOR, MULTICOMPONENT OPERATIONS, BATTELLE MEMORIAL INSTITUTE

Mr. AMBROSE. For the record, I am Tommy Ambrose, vice president of Battelle Memorial Institute. We are a research and development organization.

Battelle understands that H.R. 2820 would create a tax deduction for accrued costs of decommissioning of public utilities. Battelle sympathizes with these tax problems faced by the nuclear utilities and supports the proposed legislation.

Public utilities are not alone in facing the problems. Research organizations such as Battelle have laboratories that must be decommissioned at the end of their active lifetime. Decommissioning in this regard is a significant national problem. All the members of the nuclear community need this relief.

I use the term "nuclear decommissioning" to mean decontamination and decommissioning; and, decommissioning is an issue which is broader than just tax considerations. It is a significant public issue with tax ramifications.

My prepared testimony contains detailed arguments, but in summary the key issue is to assure financing of the nuclear facility decommissioning at the time the financing is needed. Favorable tax treatment to support a coordinated approach to financing of decommissioning is very important. However, there are a few other issues.

For example, I think that the licensee must be financially responsible. The cost of decommissioning should be borne by the present users. The public should be assured that the funds will be available when needed.

I hate to get into the aspect of doing this after the fact, where a superfund solution is required. My proposal suggests that financing decommissioning would require funds for decommissioning be placed in trust, allow tax deductions for the trust contributions, and require the Nuclear Regulatory Commission or some other Government body to monitor the level of the funding, grant tax exemption to the trust, prevent double deduction by allowing tax deductions by contributions only—not for any costs funded by the trust—and, finally, use a net present value computation for funding which takes into account the time value of money. This approach, I find, is sound.

Thank you.

[The prepared statement follows:]

STATEMENT OF T. W. AMBROSE, PH.D., VICE PRESIDENT, BATTELLE MEMORIAL INSTITUTE

Thank you for this opportunity to testify on tax deductions for future expenditures, and in particular on nuclear decommissioning costs.

I am Dr. Tommy Ambrose, Vice President of Battelle Memorial Institute. I am by training a chemical engineer with fifteeen years of nuclear reactor development and operating experience with General Electric, Douglas United Nuclear, and Battelle. I have been the Director of Battelle's Pacific Northwest Division, a group of about 3,000 employees, which operates the research laboratory of the U.S. Department of Energy's Hanford Facility. I have also had management responsibility for Battelle's privately owned nuclear facilities in Ohio.

Battelle Memorial Institute has been involved in nuclear research since 1937 when it pioneered in the use of radioactive tracers. During World War II, over 400 Battelle staff members were involved in research on nuclear metallurgy for the Manhattan Project. The original fuel rods used in the *Nautilus*, the first atomic-powered submarine, were fabricated by Battelle in 1949 using a Battelle-developed cladding process. In 1956 Battelle began to operate the world's first privately owned research reactor.

Battelle's research in the nuclear field continues unabated today. Battelle is a leader in the development of nuclear decontamination and decommissioning processes, and Battelle also is the prime contractor for the Department of Energy on several major programs for determining safe and cost-effective ways of nuclear waste disposal. For the sake of simplicity, in my comments today, I will use the term "nuclear decommissioning" to encompass decontamination as well as decommissioning.

Battelle is pleased that Congress is considering the issue of taxation of amounts set aside for future liabilities. I am not here as an expert on taxation and accrual accounting. But I am here on behalf of Battelle to ask that the area of nuclear decommissioning be given a high priority and to ask that policy issues broader than just taxation be addressed.

Battelle understands that HR 2820, which is before the Ways and Means Committee, would create a tax deduction for the accrued costs of decommissioning for public utilities. Battelle sympathizes with the tax problems faced by nuclear utilities and supports their objectives in backing proposed legislation on this issue. On one hand, many utilities are collecting funds for nuclear decommissioning as a part of their rate structure. On the other hand, these funds become fully taxable when collected, but due to the operation of the tax laws, no deduction for decommissioning

costs is available until many years later. This mismatching of income and expense should be corrected.

I hope, however, that this subcommittee understands that public utilities are not alone in facing this problem. Research organizations such as Battelle have laboratories which must be decommissioned at the end of their useful lives. Organizations engaged in the mining, fabrication, and production of nuclear materials have similar problems with their facilities. Decommissioning is a significant national problem, and all members of the nuclear community need this relief.

However, decommissioning is an issue which is broader than the tax considerations; it is a significant public policy issue with tax remifications. Battelle is concerned that as Congress addresses certain limited tax aspects of the problem, it runs the risk of not addressing other issues of public concern. I recognize that I am before a tax-writing committee, but many provisions of the tax law have been created to address non-tax social concerns. The Black Lung Trusts described in Code Section 501(c)(21) come to mind as one example.

I understand that contributions to Black Lung Trusts are tax deductible if made over a reasonable funding period on an actuarially sound basis. I also understand that the IRS has established rules for determining whether a trust is overfunded and that excise taxes are levied against self-dealing, against improper expenditure of funds, and against overfunded trusts. These rules help assure that payments into trust will be put to proper use.

Merely providing a tax deduction leaves many problems unresolved. Battelle believes that, in addition to providing tax deductions, congressional action on nuclear decommissioning should do the following:

A. It should make clear to holders of nuclear facility licenses that the primary financial responsibility for decommissioning is theirs. For example, Congress has addressed the issue of financial responsibility for low-level nuclear waste sites by requiring that the NRC obtain adequate financial arrangements for decommissioning. I am not, however, aware of any instance where Congress has explicity addressed the issue for other nuclear licensees.

B. It should create a system of allocation of the costs of decommissioning to the current users of a nuclear facility. This avoids the substantial unfairness of asking future generations to bear these costs.

C. It should provide assurances to the public at large that adequate funding for decommissioning is secure and will be available at the appropriate time.

D. It should ensure that decommissioning remains a private sector activity with some ongoing regulatory monitoring. We do not advocate the creation of a new bureaucracy to monitor decommissioning.

To accomplish these objectives, Battelle proposes these specific actions by Congress:

(1) That Congress clearly provide that the nuclear policy of the United States is for current users of facilities to be financially responsible for the clean-up costs of those facilities.

(2) That the Nuclear Regulatory Commission be required by rule to assure itself that licensees of high-level facilities are financially able to demonstrate the ability to decommission. This could be done by the establishment of a trust fund for nuclear decommissioning as a licensing condition.

(3) That each nuclear licensee which is using a decommissioning trust be required to estimate the decommissioning cost for its licensed facility and to revise that estimate periodically. These estimates would be subject to the review of the NRC.

(4) That each nuclear licensee which is using a decommissioning trust be required to make annual contributions to the trust to the extent necessary to build up adequate reserves to pay for decommissioning, thereby allowing the licensee to pass this cost on to its customers currently.

(5) That the trust, as a matter of public policy, be granted a tax exemption in a manner similar to that currently granted to Black Lung Disability Trust Funds. As a matter of equity, the grantor would, of course, receive no tax deduction for those decommissioning costs which are ultimately paid for from untaxed trust earnings.

(6) That the trust be administered by an independent third party; that the grantor not have direct or indirect use of trust assets except for actual decommissioning; that the investment of the assets of the trust be restricted to very high quality and secure instruments; and that the trust also be legally insulated from the claims of the grantor's creditors until decommissioning is complete.

(7) That after decommissioning no excess funds be returned to the grantor of the trust until the NRC certifies that the decommissioning effort is complete and no futher money is needed. As a matter of equity, any excess funds so returned would be fully taxed to the grantor.

(8) That adequate funding be set aside for the new role of the NRC, either from general revenues, higher licensing fees, or a modest excise tax on the nuclear industry.

The public is therefore better assured that nuclear sites will be cleaned up. The tax exemption for the trust minimizes the cost to the users and provides for a faster build-up of funds. And all users of nuclear facilities will pay their share of cleanup costs as the facility is used.

This forward-looking approach will avoid problems such as the one in West Valley, New York, where congressional intervention and financial support was required to resolve the problems associated with high-level radioactive waste which had accumulated over the years. It will also avoid any necessity of a Superfund-type bailout of the industry twenty or thirty years from now, involving the imposition of a large tax and the creation of a significant government bureaucracy to oversee the spending of tax collections.

Because this subcommittee has asked for input on how the time value of money should be accounted for in the deduction of future expenses, let me add that this trust fund arrangement automatically takes the time value of money into account. The actuarial determination of that annual contribution level necessary to fund a taxpayer's decommissioning liability must take into account interest to be earned over the life of the trust. Therefore, trust fund contributions will be determined using a net present value computation, meaning the amount of the total tax deductions available will be lower than the total cost of decommissioning. Since trust earnings build up tax-free, no deduction is created for decommissioning cost funded by those earnings.

I hope that you share Battelle's concerns about nuclear decommissioning. In conjunction with other Congressional committees concerned with this area, I urge you to use the Internal Revenue Code not just to solve a tax problem but to help implement an effective approach to solving the problem of funding for decommissioning which all nuclear licensees eventually face.

Chairman RANGEL. This approach also would increase the cost to the current consumers, would it not?

Mr. CRESSE. Yes; below its present level. And the details of my testimony tell you how much on a 30-year basis that would be in Florida. It is approximately 35 percent of what is presently being assessed because that would be the reduction—some $250 million over the 30-year life of the five nuclear plants we have in the State of Florida.

Chairman RANGEL. And the trustee concept, the fiduciary relationship with the utilities and the fund, it is supposed to give some assurances that, when it is time to decommission the funds would be available without any additional burdens for future consumers.

Is that the concept?

Mr. CRESSE. Yes.

Mr. HAMM. Yes, it is.

Mr. AMBROSE. Yes.

Mr. HAMM. We believe it is extremely vital. As you know in the electric industry, they admit none of us know what the financial situation will be 30 years from now. But we know that once a unit has gone critical that ultimately some decommissioning costs are going to have to be addressed. And we felt a trust proposal of some sort with oversight by the State commissions will protect those consumer interests.

Chairman RANGEL. Are there any current estimates of what the cost of decommissioning one of these plants is?

Mr. CRESSE. Yes, sir; we, in Florida, today, sir, are funding the decommissioning cost based on the best evidence that we got in an evidentiary hearing before experts in this subject. I have to tell you that since they have not done much of it, anybody that claims to be

an expert is probably wrong. But, on the other hand, you have to deal with some figures.

We brought in experts. We had NRC estimates of the cost of decommissioning plants. We took the best figure and we provided three options in which that is presently approvable, and we took the lowest cost option that meets NRC guidelines and started funding that currently under the principles that we talked about with Mr. Gibbons.

The problem is, we are currently funding that and we require that money be held separately in a separate internal fund of the company so that the benefits of the use of that will go to the cost of that decommissioning.

So we are handling it, I think, in a way that come that year, the money will be there. Obviously, our order says it will be reviewed at least every 5 years, and more frequently if any party to that document believes the estimates are wrong or that they have better data that would revise the amount we are collecting at the present time.

Chairman RANGEL. When would we be expected to do our first decommissioning?

Mr. CRESSE. I truthfully cannot answer that because I don't know when the first plant was built throughout this Nation. It would be pure speculation if I tried.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. I have no questions, Mr. Chairman.

Mr. HAMM. I think I could answer the question just from knowledge from plants in South Carolina. There is an argument that one of Carolina Power & Light's plants could be subject to decommissioning within the next 10 years due to certain embrittlement problems.

You asked about decommissioning. In a hearing that took place less than 1 month ago, I can give you a specific answer for one utility, and in that situation a plant was brought on line in an ultimate construction cost of $1.3 billion. The evidence presented by that utility during the course of that rate proceeding, they made a request that was ultimately approved by the South Carolina Public Service Commission—and my office did not oppose this—they are concluding that that $1.3 billion plant will cost $100 million to decommission at the end of its 30-year service life.

Chairman RANGEL. Mr. Gibbons.

Mr. GIBBONS. Let me ask Mr. Cresse this, and perhaps other members of the panel. I realize Dr. Ambrose has a different problem than the two of you are talking about, but it is all on the same subject.

Are there some utility commissions not requiring the current setting aside of money for decommissioning these plants?

Mr. CRESSE. I have not made a State-by-State survey, but I do understand that some are not doing it at the present time pending the tax deductibility issue. It is kind of perplexing to them in terms of how they should handle it.

If it is not a true operating expense, as the IRS says it is not, there is a question in many utility commissioners' minds whether or not they could allow it to be collected, because all you can recover from the ratepayers is appropriate expenses. So I am sure some

of the regulators throughout the country are concerned about the dichotomy that they are saying something is a current operating expense and the IRS says it is not.

But I have not made a 50-State survey. I will try to get as much information as I can and get it back to you.

Mr. GIBBONS. Yes.

Mr. HAMM. The answer that Commissioner Cresse is giving is accurate. There are some States not doing that. What some have done in an attempt to begin to address this problem is to make an addressment specifically in the area of depreciation expenses and change their service lives of the plant that provide for net salvage value. But in those areas where the internal funds are going, they are not separate funded reserves.

So the question that comes up, say this legislation is passed, and the commission in those jurisdictions says we want a separate funded account to insure the funds are available, there is a concern on the part of my organization that the utility would say: "No, you can't do that. If you do, we will not be able to collect the funds on a tax deductible basis."

Mr. GIBBONS. What I understand you all to be advocating is a separate-funded reserve; is that correct?

Mr. CRESSE. Well, sir, let me respond to that. We are not advocating—I am not—that Congress require a separate funded reserve. I think what we are advocating is that we have the ability to require it; that there would be no IRS saying if we do that it will become taxable. That is the concern expressed.

I frankly think we have required a separately funded reserve for these moneys because we felt that that was in the best interests of the best use of the funds' long term. But that doesn't mean that something could not happen in the next 15 years, that a better alternative might be available to the ratepayer.

I would want the option of considering that better alternative based on the evidence, though, that we had. It should be the cheapest and should guarantee that the dollars will be there when the dollars are needed. I wouldn't want Congress to preempt us and mandate that, but neither do I want IRS to say you can't do it that way. That is basically our concern on that subject.

Mr. HAMM. That is an accurate response.

Mr. AMBROSE. Yes.

Mr. GIBBONS. Now, the problem arises because of IRS stance. If I am putting words into somebody's mouth, please correct me. The fear that the regulators have is that the IRS is going to say that the funds that go to these reserves are taxable income but are not a deductible expense until way out at the end.

Is that correct?

Mr. CRESSE. That is exactly correct.

Mr. AMBROSE. Yes.

Mr. HAMM. That is right.

Mr. GIBBONS. You got a whole different set of ratepayers and different set of—you know, I hope those plants in Florida are going to outlive me, and I hope most of the nuclear plants are going to outlive a lot of the ratepayers, and I can't see much good that a deductible expense way out on the end will do the current ratepayer any good.

Am I correct in that?

Mr. CRESSE. Yes, sir, you are correct. As a matter of fact, because we are trying to be fiscally responsible so that that future generation will not pay that, today we are having—we are requiring—and the IRS interpretation of existing law allows us to collect more from the existing ratepayer than is necessary because they are taking—they and the state are taking 47 percent of every dollar for taxes, and it is wrong.

Mr. GIBBONS. What you are saying is we got the incentives in the wrong place?

Mr. CRESSE. Exactly.

Mr. GIBBONS. We are encouraging people to do what is wrong; in other words, put the payment over to the future because the current taxes are just too much of a burden. Is that right?

Mr. CRESSE. Yes, sir; you know it was not so long ago that a great concern of a lot of folks was whether or not the electric industry was healthy because of the irresponsibility of the State legislators.

You all may have heard some of that in the last 5 years and here, we are exactly the opposite, where we try to be responsible and we try to pay $2 for $1 and we ought to get the pot right and treat it right so future generations don't have to pay for the benefits.

Mr. GIBBONS. Well, thank you very much.

Chairman RANGEL. I don't know, Mr. Gibbons. What we appear to be saying is that in the years ahead, the cost of the service is going to be higher than it is initially. In most other scientific advances, we believe the expenses are up front, and future consumers receive the benefit of our technology. Since it would be so improved, we would be surprised at the consumer cost when the technology was first introduced.

Now, we are saying that we are the beneficiaries of a free ride, because the ultimate cost of the service is going to balloon at the end. We are now protecting our children and our grandchildren against expenses that will far exceed that we are paying now.

This is a very unusual approach to a scientific contribution for services.

Mr. GIBBONS. Mr. Ambrose, you are in a private laboratory, you are not a regulated utility. You apparently deal with some toxic substances?

Mr. AMBROSE. Nuclear as well as toxic substances.

Mr. GIBBONS. You are going to have decommissioning costs, too.

Mr. AMBROSE. That is right, and we are accruing for those right now in a reserve fund. As I have suggested---

Mr. GIBBONS. The bill I have wouldn't affect your situation at all?

Mr. AMBROSE. I propose it could be broadened to cover us.

Mr. GIBBONS. We got to get this through first. Here we have regulated public utilities that are really unique in our society. You may think of yourselves sometimes as a utility, but you are really a private concern.

However, let me commend you for worrying about the decommissioning costs. I would much rather have you worry about it now than require us to then set up another superfund. We are doing that in an oil cleanup program down in my State, and the Federal

Government is picking up one fantastic amount of money to haul dirt off, purify it, and clean up wells, and everything else.

You are progressive in your thinking. We are having a hard enough time swallowing the utility thing right now. I am not going to tell you to come back later, but let us get a little experience here on the utility side with the negative-salvage value.

Mr. HAMM. Handled through a depreciation method, yes, sir.

Mr. AMBROSE. May I make one comment?

We are actually marketing research and development to utilities, and by law, there are only certain things that they can pay for. In our costs of doing this work for them, we show a decommissioning cost and they stick on these, and we are with no way to cover these costs.

We have been caught in the past where we have had to cover it out of our own earnings and in the research business, that is such a narrow line, it has really given us troubles.

Chairman RANGEL. We are deeply appreciative of the panel bringing this problem to the attention of the committee.

The Chair would now like to go back to the regular order and call Richard Helfand, tax partner, head of the tax specialty team; Albert Ellentuck, chairman of the Federal Tax Executive Committee of the American Institute of Certified Public Accountants; and Gerard Brannon, director of special projects, American Council of Life Insurance.

STATEMENT OF RICHARD A. HELFAND, TAX PARTNER AND DIRECTOR OF THE TAX SPECIALTY TEAM ON ACCOUNTING METHODS, ARTHUR ANDERSEN & CO.

Mr. HELFAND. My name is Richard A. Helfand. I am a partner in Arthur Andersen & Co., and director of our accounting methods tax practice team.

We welcome the opportunity to testify before this subcommittee today on proposed legislation dealing with premature accruals of deductions for tax purposes. The views expressed today are those of the firm itself, and not of our clients.

Mr. Chairman, we have reviewed the Treasury Department's factsheets on tax proposals concerning premature accruals which were part of the President's budget message.

Since the explanations of the principles underlying the proposed legislation have only recently been released, our comments must necessarily address the general concepts contained in these proposals.

While there is theoretic merit in the objectives of these proposals, in application they would impose an unacceptably broad revision to long-established tax accounting principles.

Accordingly, we recommend that:

One, proposals broadly encompassing premature accruals should not be adopted. Should a determination be made that deductions for a particular accrual are inappropriate, specific legislation addressing that accrual should be enacted.

Two, if the rules concerning premature accruals are adopted as proposed, then deductions for payments to a reserve fund should be considered in certain circumstances.

A basic concept underlying accrual-method accounting is the matching of revenues with the costs associated with the earning of such revenue.

In various circumstances, the Internal Revenue Service has noted the importance of this matching concept indicating that it is inherent in the concept of clear reflection of income.

The premature-accruals proposal would violate this matching concept by deferring deductions in certain circumstances substantially beyond the period in which related income would be reported.

This would apparently be accomplished by redefining the all-events test to defer deductions that presently clearly meet that test and are permissible rather than premature deductions.

The proposal attempts to deal with this mismatching by expanding the net-operating-loss-carryback provisions. The operation of these provisions suggests that the premature-accruals legislation is improper and unnecessary.

Indeed, these expanded NOL provisions recognize the economic fact that the deductions in question relate to income that would have already been reported.

The premature-accruals proposal also represents a significant departure from financial accounting principles. Although financial and tax accounting have divergent goals, the numerous similarities between the two methods have permitted financial-accounting income to act as a strong foundation for the determination of taxable income and an aid in the administration of our tax system.

If the premature-accruals proposal and other measures, such as the proposal relating to deferred payments which could apply to the same transaction, are enacted, it is clear that such reliance of financial accounting could not continue.

Our understanding of these proposals to deny deductions for certain liabilities is that the all-events test would become a three-prong test requiring that economic performance occur in order for an amount to be deduction.

Unfortunately, "economic performance" is a new and undefined term with many potential interpretations. It is obvious that these rules would become the source of substantial litigation even assuming timely issuance of regulations and rulings defining the interrelationships and fundamental nature of these concepts.

The premature-accruals concept will also likely frustrate public-policy goals pursued by Congress, other agencies of the Federal Government or agencies of State and local government.

Many of the perceived areas of concern discussed in the report of the Joint Committee of Taxation involve compliance with Federal, and State, and local government-mandated programs designed to accomplish important social objectives.

Deferring deductions for these purposes is inconsistent with the underlying objectives for which they are required.

For these reasons, we have concluded that the premature accruals proposals should not be adopted. Rather than dealing directly with the specific issues involved, the Treasury has proposed sweeping legislation.

In making this recommendation, we recognize that certain taxpayers may be permitted current deductions for amounts payable

in the future, overstating the true cost of the expense when taking into account the time value of money.

On the other hand, the acquisition of fixed assets or inventories and the subsequent charge of costs to depreciation of cost of goods sold also ignores time value of money concepts.

A taxpayer paying current dollars for these items may not be entitled to a deduction for these expenditures for several years. Similarly, items of accrued income, such as sales and service income or income from settlements, that may not be received for several years are reflected in taxable income using current dollars rather than their present value.

Proposals dealing with only limited aspects of the time value of money issue are unfair to taxpayers and cannot be theoretically supported.

Moving to a hybrid method that accrues income but allows deductions on an as-paid basis is not a solution to the perceived abuses. It is a revolutionary concept that creates undue complexities and appears driven by revenue considerations rather than a desire to correct the tax accounting system.

[The prepared statement follows:]

STATEMENT OF RICHARD A. HELFAND, PARTNER, ARTHUR ANDERSEN & CO.

My name is Richard A. Helfand. I am a partner in Arthur Andersen & Co. and director of our Accounting Methods Tax Practice team. We welcome the opportunity to testify before this subcommittee today on proposed legislation dealing with deferred payments and premature accruals of deductions for tax pruposes. Ours is an international accounting firm with offices in major parts of the world. While we have many clients affected by the proposals under consideration, we do not represent these clients in testifying and the views expressed today are those of the firm itself.

Mr. Chairman, we have reviewed the Treasury Department's fact sheets on tax proposals concerning deferred payment transactions and premature accruals which were part of the President's budget message. We have also reviewed the pamphlet prepared by the staff of the Joint Committee on Taxation dated February 17, 1984, entitled "Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions" and the "General and Technical Explanation of Revenue Proposals Contained in the Administration's Fiscal Year 1985 Budget" released by the Treasury Department February 17, 1984. Since the explanations of the principles underlying the proposed legislation have only recently been released, our comments must necessarily address the general concepts contained in these proposals.

While there is theoretical merit in the objectives of these proposals, in application they would impose an unacceptably broad and complex revision to long established tax accounting principles. Accordingly, we recommend that:

(1) Proposals broadly encompassing premature accruals should not be adopted. Should a determination be made that deductions for a particular accrual are inappropriate, specific legislation addressing that accrual should be enacted.

(2) If the rules concerning premature accruals are adopted as proposed, then deductions for payments to a reserve fund should be permitted in certain circumstances.

(3) Effective date provisions should grandfather existing transactions and provide appropriate opportunity to evaluate the effects of the legislation prior to its application. We suggest that any new legislation in these areas apply transactions completed after December 31, 1984, which were not subject to a binding obligation as of that date.

(4) The rules relating to deferred payment transactions should be enacted but should be limited in application to transactions involving tax shelters. Furthermore, proposals for the determination of an applicable test rate should be simplified.

GENERAL COMMENTS

With minor exceptions, our tax accounting system ignore the time value of money for items of income or deduction. The failure of the current system to recognize the time value of money can probably be attributed to two factors.

First, it is only within the last 10 years that market interest rates have been high enough to dramatically impact the present value of deferred income or deductions. As a consequence it was unnecessary to adjust the focus of the tax accounting system from its reliance on historical costs for the relatively minor distortions that resulted from the failure to present value.

Secondly, it is widely recognized that any effort to incorporate present value concepts by adjusting the monetary value of income and deductions would add complexities to the tax laws for both the government and taxpayers, especially smaller taxpayers. Experience has demonstrated that time value of money concepts can be a dangerous trap for the unsophisticated taxpayer. Congress recognized that fact when it passed the Installment Sales Revision Act of 1980. In that legislation, the 30% limitation on the amount of consideration received in the year of sale for certain installment sales was repealed, primarily due to the fact that the presence of imputed interest often caused taxpayers inadvertently to receive excess consideration in the year of sale. Obviously, efforts to introduce these concepts as fundamental principles of tax accounting potentially affecting all taxpayers must be approached with extreme caution.

PREMATURE ACCRUALS

A basic concept underlying accrual method accounting is the matching of revenues with the costs associated with the earning of such revenue. In an early tax decision the Supreme Court held that taxpayers should be permitted to use the accrual method of accounting, hence to charge against income earned during the taxable period, the expenses incurred in earning income during that period.

In various circumstances the Internal Revenue Service has noted the importance of this matching concept indicating that it is inherent in the concept of clear reflection of income. The Internal Revenue Service has indicated that the accrual method of accounting accurately reflects the annual increase or decrease in the asset, liability, and net worth position of a company as shown on its books and records, and as verified by its financial statements.

The premature accrual proposal would violate this matching concept by deferring deductions in certain circumstances substantially beyond the period in which related income would be reported. This would apparently be accomplished by redefining the all events test to defer deductions that presently clearly meet that test and are permissible rather than "premature" deductions. The proposal attempts to deal with this distortion by expanding the net operating loss carryback provisions. The operation of these provisions suggests that the premature accrual legislation is improper and unnecessary. Indeed, these expanded provisions recognize the economic fact that the deductions in question relate to income that would have already been reported.

The premature accrual proposal also represents a significant departure from financial accounting principles. Although financial and tax accounting have divergent goals, the numerous similarities between the two methods have permitted financial accounting income to act as a strong foundation for the determination of taxable income and an aid in the administration of our tax system. Present Treasury regulations reinforce this principle by providing that "a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income provided all items of gross income and expense are treated consistently from year to year."

If the premature accrual proposal and other measures, such as the proposal relating to deferred payments, are enacted, it is clear that such reliance on financial accounting could not continue. Accordingly the burden on both taxpayers and the government in complying with the new system would be substantial. One of the fundamental strengths of our present tax system is the high degree of compliance on a self-assessment basis. This aspect of our tax laws, which is largely based upon the overall fairness of the laws, must be preserved in order to maintain the integrity of the system. The current proposals may depart from these fairness considerations.

Our understanding of the proposal to deny deductions for certain liabilities is that the "all events" test would become a three prong test requiring that "economic performance" occur in order for an amount to be deductible. Unfortunately, "economic

performance" is a new and undefined term with several potential interpretations. The explanation prepared by the staff of the Joint Committee on Taxation suggests that economic performance occurs generally when services are performed, property provided, use of property occurs and in the special case of workmen's compensation or similar liability, when the liability is satisfied. We understand that the deferred payment proposal and the premature accrual rules could apply consecutively to the same transaction. Once economic performance occurs, the deferred payment rules would apply to allow the taxpayer a discounted deduction at that time with the balance constituting interest expense allocated over the remaining period until ultimate payment. The possible application of both the premature accrual and deferred payment rules to a single transaction represents an extraordinarily complicated tax accounting result.

For example, if a taxpayer entered into an agreement to rent property for five years with all of the rent being due at the end of the rental period, a premature accrual could initially result. However, as time elapsed economic performance would—presumably begin to occur thereby triggering application of the deferred payment rules as to that element of the obligation. Presumably the necessary computations involved in the switch from premature accrual to deferred payment treatment would occur on a periodic basis, perhaps monthly. With changing interest rates and the declining amount of the remaining premature accrual, the amount of the taxpayer's annual deductible expense could fluctuate significantly even though such fluctuations would not have been present had interest been explicitly provided on the unpaid rent. It is obvious that these rules would become the source of substantial litigation, even assuming timely issuance of regulations and rulings defining the interrelationships and fundamental nature of these concepts.

The premature accrual concept will also likely frustrate public policy goals pursued by Congress, other agencies of the federal government or agencies of state and local government. Many of the perceived areas of concern discussed in the report of the Joint Committee of Taxation involve compliance with federal, state and local government mandated programs designed to accomplish important social objectives. These include expenditures for mining reclamation, nuclear power plant decommissioning, workmen's compensation and other similar expenses. Deferring deductions for these purposes is inconsistent with the underlying objectives for which they are required and with the concept that affected taxpayers have a social obligation to incur future costs associated with their current income producing activities.

It is important to note that several bills are pending that would permit either a current deduction for these liabilities or a curently deductible contribution to reserves established for the ultimate payment of these liabilities. Inherent in these bills is an understanding that public policy objectives have created undue economic hardship for certain industries. It is ironic indeed that legislation affecting all taxpayers is being considered because of concerns about deductions for reclamation expenditures, nuclear decommissioning costs, etc., while at the same time Congress is also considering exempting these transactions from the application of this legislation.

For these reasons we have concluded that the premature accrual proposals are contrary to well defined and accepted tax accounting principles and should not be adopted. Rather than dealing directly with the specific issues involved, the administration has proposed sweeping legislation that would remove an important element of accrual method reporting. However, should these proposals be adopted we strongly urge that in certain circumstances taxpayers be permitted to make deductible contributions to reserve funds to provide for the payment of long-term liabilities in an orderly manner.

DEFERRED PAYMENT TRANSACTIONS

The Administration's legislative proposals concerning deferred payment transactions represent a major revision to our long standing and highly evolved tax accounting system and are likely to have far broader application than the drafters envision. Besides applying to currently deductible items, these rules could potentially apply to capital assets and deferred costs such as start-up expenditures. The new rules would also conflict with the cost recovery or amortization deductions generated by these assets.

Also of concern is the possible application to inventoriable costs and the determination of the cost of goods sold. Problems of allocating deferred deductions to goods sold and still on hand could arise. Similar allocation problems could arise with respect to income reportable under installment and long-term contract tax accounting rules. Further complications could arise in connection with the application of these

rules when affected assets and liabilities are sold, distributed or assumed in the context of taxable or tax-free transactions.

Complex changes affecting all taxpayers are particularly inappropriate in view of the Treasury Department's current efforts to simplify the Internal Revenue Code in a meaningful way and thereby simplify the tax collection process. The proposed legislative changes would result in many complicated new concepts that would be difficult for taxpayers to comprehend and for the Internal Revenue Service to administer. In effect a new and complicated hybrid method of accounting would be created which could have a transitory existence.

In our view there is a necessity for and merit to the proposals for deferred payment transactions. However, we believe that these provisions should be directed at the abuses they are intended to correct rather than apply to all taxpayers and to all commercial transactions. Accordingly, we recommend that as in the case of the expense prepayment rules only tax shelters be subjected to these provisions. A tax shelter for this purpose would have the same meaning as used in the prepaid expense provisions—i.e., (1) a partnership or other enterprise (other than a corporation which is not an S Corporation) in which interests have been offered for sale, at any time, in any offering required to be registered with a federal or state agency; (2) a partnership or other enterprise if more than 35% of the losses are allocable to limited partners or limited entrepreneurs (generally investors who do not actively participate in the management of the enterprise); or (3) a partnership, entity, plan or arrangement which is a tax shelter within the meaning of Section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of federal income tax). This recommendation is similar to recent Senate Finance Committee proposals.

In making this recommendation we recognize that certain taxpayers may be permitted current deductions for amounts payable in the future, overstating the true cost of the expense when taking into account the time value of money. On the other hand, the acquisition of fixed assets or inventories and the subsequent charge of costs to depreciation or cost of goods sold also ignores time value of money concepts. A taxpayer paying current dollars for these items may not be entitled to a deduction for these expenditures for several years. Similarly, items of accrued income, such as sales and service income or income from settlements, that may not be received for several years are reflected in taxable income using current dollars rather than their present value. Proposals dealing with only limited aspects of the time value of money issue are unfair to taxpayers and cannot be theoretically supported.

We do, however, view the proposals for the applicable test rate applied to deferred payment transactions to be complex and unworkable. The use of three separate discount rates adjusted semiannually will create confusion in actual application.

SUMMARY

The perceived abuses addressed by the legislative proposals can and should for the most part be effectively dealt with under existing statutory and judicial principles. These principles can be applied to potentially abusive deductions. Most notable is the clear reflection of income standard embodied in Internal Revenue Code Section 446(b) that has been effectively utilized by the Internal Revenue Service and the courts to define the limits of acceptable accrual method tax accounting. New enforcement tools such as the substantial authority provisions, the abusive tax shelter program and the "more likely than not" standard for tex shelters are also available. The Internal Revenue Service need not wait for litigation to further define these concepts. Published rulings could be issued to express IRS views and provide more guidance to taxpayers.

Moving to a hybrid method that accrues income but allows deductions on an aspaid basis is not a solution to the perceived shelter abuses. It is a revolutionary concept that has undue complexities and appears driven by revenue considerations rather than a desire to correct abuses.

In view of the nature of the proposed changes and their complexity, caution is urged with respect to transitional rules. Inasmuch as this legislation would substantially change the economics of transactions already undertaken it is urged that appropriate grandfathering provisions be adopted. For the same reasons we suggest that any new legislation in these areas provide an effective date for transactions completed after December 31, 1984, or subject to a binding obligation as of tht date.

We believe that the fundamental issues addressed by the proposed legislation are significant in their impact. However, we urge the Subcommittee to deal with perceived abuses in a specific manner. The goal of the drafters to recognize time value of money concepts is laudable, but unfair or unrestrained legislation is destined to undermine the self-assessment system. Sweeping revisions of the current tax ac-

counting system should only be considered as a last resort and only after the extensive study which is presently being undertaken by the Treasury Department.

We would like to thank you for the opportunity to testify at this hearing. We urge the Subcommittee to consider our recommendations before completing action on this important legislation. We will be pleased to answer any questions that members of the Subcommittee or its staff may have concerning our comments and recommendations, or to furnish any additional information which may aid in the deliberations regarding these proposals.

Chairman RANGEL. Mr. Ellentuck, please proceed.

STATEMENT OF ALBERT B. ELLENTUCK, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ELLENTUCK. Good morning.

My name is Albert B. Ellentuck, and I am chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants. The American Institute of CPA's has more than 200,000 members and is the primary professional organization working with generally accepted accounting principles and with the tax law which you helped to write.

We are vitally interested in financial and tax accounting issues, and strive to serve the public in these areas.

The accrual method of accounting was developed to properly match expenses with related revenue to clearly reflect income, and this method has been refined over many, many years.

We believe this principle should be adhered to in considering specific proposals relating to the timing of the recognition of income and deductions.

This committee is focusing on how to apply this principle to very long-term obligations which a taxpayer is committed to, often by mandate, such as strip mining reclamation, nuclear powerplant decommissioning, workmen's compensation, supplemental unemployment benefits, and plant closings.

Clearly, a taxpayer may derive a benefit from the present deduction of an accrued liability which may not be paid for many years. The difference between the current tax benefit and the present value of the deferred payment may, in some situations, be a substantial amount.

In fact, extreme situations may arise where the time period between accrual and payment is so long that the tax benefit may exceed the present value of the postponed payment.

In order to realize such benefit, however, the taxpayer must have satisfied the recognized all-events test to establish the liability for income tax purposes. Under this test, all events must have occurred to establish the fact of the liability and the amount must be capable of determination with reasonable accuracy.

This test has remained unchanged in the regulations for a long time. We believe that the test provides a fair and ascertainable standard in most business situations for purposes of both tax accounting and generally accepted accounting principles.

In order to deal with the problem of extremely long-term obligations, we would suggest a method whereby the obligation is accrued when it is established under the all-events test and is amortized over the period to which it applies and in which it generates revenue.

This is in contrast to the Treasury proposal, released in the last few days, which effectively would place taxpayers on what amounts to a cash basis for recognizing the obligation and obtaining a tax deduction.

And, it is in contrast to the Senate Finance proposal which would offer the taxpayer the option of claiming a current deduction of the present value of the future obligation or waiting until the end of an extended period for a deduction of the total amount incurred.

We believe that it is inappropriate to discard an established tax principle, such as the accrual method using an all-events test, and substitute the cash method of Treasury or the hybrid method of Senate Finance.

We believe that these proposals fail, in most situations, to properly match revenues with expenses and would create distortions of income. In response to this potential problem, Treasury has offered an extension of the net-operating-loss carryback rules.

This solution is complex, would be inequitable where there is insufficient income against which to carryback the loss, and does not cure the problem of mismatching revenues and expenses.

In effect, taxpayers' money, attributable to the obligation, would be on deposit with the Government for an extended period of time.

As indicated, a method which would more appropriately match revenues and expenses, and which applies to the specific situations under review, would be a method which recognizes the all-events test for the establishment of the liability, but amortizes that obligation over the period in which it produces revenue.

We believe that such an approach would be simpler and certainly more equitable because it results in the matching of revenue and expense without disturbing the all-events test.

As a matter of fact, such matching has a number of precedents in present tax law such as the income-projection method of the movie industry, oil and gas cost depletion, and tract-housing construction.

If the type of legislation being proposed by Treasury or Senate Finance is nevertheless pursued, two further factors should be considered.

First, the application of the legislation should be specifically limited to problems causing concern, such as strip mining reclamation, nuclear powerplant decommissioning, workmen's compensation, supplemental unemployment benefits, and plant closings.

Second, it should apply to the revenue side of accruals as well as to the expense side. Although a specific listing of affected transactions is more difficult to develop on the revenue side than on the expense side, a simple example here may assist the subcommittee.

I think it was Mr. Duncan that asked for an example of a revenue side distortion, and may I give you one?

If a company is awarded a judgment of $10 million in damages, payable over 10 years, under current law it must accrue the revenue immediately under the all-events test. This could result in a payment of almost $5 million in tax, with the receipt of only $1 million in revenue in the first year.

Thus, the Government would get the time value of the taxpayer's money between when he pays the tax and when he actually re-

ceives it. As the Government has indicated on the expense side, the tax paid currently may be greater than the time value of the revenue collected over the period.

In summary, we believe that the all-events test has served the tax system well in most cases, and that perceived problems should be dealt with specifically on their own merits.

In developing legislation to deal with specific problems, we believe that a method of accounting such as we have described would be preferable to Treasury and Senate Finance proposals.

If these latter proposals are nevertheless pursued, parallel treatment should be provided on the revenue side for the sake of fairness and logic in the tax system.

I would be happy to answer any questions you may have.

Chairman RANGEL. Mr. Brannon.

STATEMENT OF GERARD M. BRANNON, DIRECTOR OF SPECIAL PROJECTS, AMERICAN COUNCIL OF LIFE INSURANCE (FORMER ASSISTANT SECRETARY OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY)

Mr. BRANNON. Thank you, Mr. Chairman.

I would like to summarize my statement, and assume that the pleasantries are included in the record.

I am appearing as an independent witness. Basically, I agree with the points that the Treasury has made about the importance of taking account of the time value of money, but I think the problem is really quite complex, and there were some confusions in the basic Treasury analysis of this problem in their testimony on surface mining legislation last year.

What I have tried to do in my testimony is construct a very simple example which tries to bring out the particular point at issue which comes down to whether or not you take account of the before-tax or after-tax rate of interest in the discounting.

My simplified example is that a taxpayer sells for $98 a contract that is accurately estimated to cost $100 to fulfill in five years. The occurrence is at the end of the 5 years. The tax rate is 50 percent. The before-tax interest rate is 10 percent, and there are selling costs connected with the contract of $20.

There are four ways the future costs of $100 might be handled. One is to deduct the future costs when it happens, out in year 6. Another is to deduct $78 now, which is $100 discounted for 5 years at the after-tax interest rate of 5 percent, and then to take no more deductions.

A third method is the traditional reserve method, you would deduct now $62, which is the current value of $100 discounted at 10 percent, but then deduct the difference between $62 and $100 in later years as the expenditure comes closer to the current period.

A fourth method is to deduct in year 1 the full $100, which is what present law allows when the all-events test is met. Treasury is basically right in their position that method 4 is wrong. It allows too much of a deduction, because it does ignore the time value of money.

The next part of the Treasury position is the complicated one. They say that taking account of the deduction early should really

be by way of method 2; that is, you discount the $100 down to $78, and that is the end of it. You take it once, and you really lose part of that $100, because taking it early is a net advantage and they say you ought to pay something for having that advantage.

Once they make that point, they are correct that this is no better for the taxpayer than method 1, which is to deduct the thing when it happens, and then under method 2 there would be a lot of complicated reserve keeping, so they say let us skip the whole thing and stick with method 1.

I disagree because of the issue of how you do the discounting. The Treasury says that if a further deduction is to be taken early, you ought to pay for it by cutting the amount of the deduction. I think the right answer is No. 3, there should be some advance, but the taxpayer should still get the full deduction.

Now, to focus on this issue, the first thing I do is to construct a case where the Treasury is obviously right. Say we had a system where the Treasury agreed with me that I was going to make a contribution to charity in 5 years. I want to take the deduction now. It obviously should be deducted in 5 years, so the Treasury could very well say if I want it now, I have to discount it, take something like $78 and that is the end of it.

What the people who are talking about this reserve discounting are saying is that things like future costs are different from a charitable contribution that really belongs in year 5 because these future costs are connected with the present income. In my case you do not get that present $98 unless you make the commitment. You do not get the present receipt for the contract unless you make the commitment to fulfill the contract in 5 years.

Now, why should that connection really make such a big difference? My testimony makes the point of saying that profit on the sale of the service contract in a no-tax world would be exactly the same as profit on a similar contract in which you sell for $98 a pair of shoes which cost $62 to make—$62 was the present value of the future commitment—and where you had the same selling costs, $20.

In this no-tax world, the service contract that I described would come out with exactly the same profit as this sale of shoes. Under the Treasury proposal, I show that with a 50-percent tax they would still tax the pair-of-shoes case at $10. They would tax the sale of a service contract at $20. The effective tax rate on that service contract goes up from 50 percent to 100 percent.

Now, I think 100 percent is a bit too high as tax rates go, and I think that demonstrates the basic issue in a rather simple way. Mr. Sunley has produced a far more complex illustration which is basically sound. I believe this simple example shows the principles that Mr. Sunley was talking about.

I would agree further with the kind of things that have been said, that this is a very complicated situation, where the practical problems are difficult, and I would commend to you Mr. Lewis' advice to not do things hastily.

In particular, it looks like this kind of discounting is very similar to a problem in property and casualty insurance. Last year, the Treasury identified its position on strip mining replacement problems with the position on this estimate reserve in property and cas-

ualty insurance. Now, I understand they have some reservations about the identification. I suggested in my testimony some reasons why the particular property-casualty problem is quite different, and in that case, you should not do the discounting, because there is an opposite mistake on the side of the party who is insured.

Thank you.

[The prepared statement follows:]

STATEMENT OF GERARD M. BRANNON, DIRECTOR OF SPECIAL PROJECTS, AMERICAN COUNCIL OF LIFE INSURANCE

Mr. Chairman and members, I Gerard Brannon. I have worked at various stages in the tax legislative process from Congressional staff to Treasury, to teaching and writing on public finance, to working for a trade association. I am presently employed by the American Council of Life Insurance but I am testifying as an independent witness, not in behalf of the Council.

I want to discuss some theoretical ideas about the timing of deductions. These ideas go back to my Congressional staff days when I worked on the notorious sections 452 and 462, but they have been much affected by recent discussions with some fellow tax economists.

A BASIC EXAMPLE

The various viewpoints have been expressed in very complicated terms. I will try to limit myself to a quite simple example in which I can conveniently describe the different possible treatments. This presentation should help you think about these treatments and reach your own conclusions.

My particular illustration will be close to the kind case used in the Treasury Appendix to its testimony of May 23, 1983 on mining reclamation. It is agreed among us technicians, including those in Treasury I understand that the Treasury Appendix created some confusion in the way it referred to specific interest rates, so I will change the case by using my own interest rates. The bare bones case is this :

(a) the taxpayer undertakes a commitment which is (accurately) estimated to cost $100 to discharge in 5 years;

(b) the before tax interest rate is 10%;

(c) the tax rate is 50%;

(d) the taxpayer receives now $98 for undertaking this commitment; and,

(e) the taxpayer has selling costs in year of $20.

You can think about this as a service contract but it is a general illustration.

THREE POSSIBLE TREATMENTS

To get a handle on the issues, think about 3 possible tax treatments of the cost: (we always include the $98 in current income):

Method (1).—Deduct $100 when the costs arises 5 years later, in year 6.

Method (2).—Deduct in year 1 $78 which is $100 discounted 5 years at the after-tax interest rate of 5%; deduct nothing more in later years.

Method (3).—Deduct the full $100, $62 in year 1, and $6,7,8,8,9, in the next 5 years respectively. (This is discounted reserve accounting.) The reserve in year 1 is $100 discounted 5 years at the before-tax interest rate. In year 2 the reserve rises by $6 because the obligation is discounted for only 4 years, etc.

Method #1 is the present law accrual accounting rule that applies in most all cases of this type. Method #2 at first blush looks bizarre because it means that the taxpayer is not getting to deduct the full cost. We would get to method #2, however, if we started out by assuming that method #1, deduct in year 6, was right. It would follow from this assumption that it would be more valuable to the taxpayer to deduct $100 in year 1 than in year 6; therefore it follows that if the taxpayer wants to deduct early, the right treatment is to eliminate this advantage by reducing the total amount to be deducted.

The thing for you to remember in thinking about method #2 is that it allows an advance deduction to future costs but it requires that the taxpayer pay a price for this advance by giving up some deduction.

In method #3, the taxpayer has his cake and eats it. The taxpayer gets some advance deduction (not as much as in #2) but there is no price exacted; eventually the full cost is deducted.

The thing for you to remember in thinking about method #3 is that it is better for the taxpayer than #1; there is some advance and full deduction.[1]

The Treasury Appendix establishes that method #1 and #2 provide exactly equal benefits to the taxpayer. The Treasury believes that method #1 is theoretically adequate. In effect, their argument is that if any deduction is taken early there should be a price in terms of some lost deduction. Since the advance deduction on these terms is no better for the taxpayer than waiting to year 6, Treasury concludes that all the bother of setting up the reserve is not worthwhile.[2]

Some other witnesses, esp., Dr. Sunley, argue for method #3 saying that the Treasury is demanding too high a price for advance deduction. Sunley wants some advance plus full deduction of the $100.

CHOOSING BETWEEN THE METHODS—THE TREASURY CASE

Now we have the alternatives before us, and the two viewpoints on the alternatives. How do we decide who is right?

My way of fucusing on "who's right" is to start off by slightly changing the story behind the example to find a case where Treasury is clearly right. Then we can focus on precisely why the other side can say that business cases, like mine reclamation expenses are different.

Let's agree that I will in fact give $100 to charity in 5 years. Assume that Treasury agrees that I am a man of my word and really will contribute. I might go to Treasury with this bargain "I will forego the deduction of $100 in year 6, if you will let me deduct $78 this year." Given my assumption of a 10% interest rate and a 50% tax rate, this is a fair deal for the Treasury. I have constructed a case where clearly the $100 ought not to be deducted until year 6. In this case Treasury should say that if I want the deduction early I should pay for it by giving up some of the deduction. (I am not advocating that we institute a system of taxpayers bargaining with Treasury about advancing deductions. All I am saying is that if we had such a system it would require that there be a price for the advance, that I get less than the full $100 deduction.)

In the testimony last year on mine reclamation costs, the Treasury argument came down to something very close to saying "Mine reclamation deductions belong in year 6 and moving them up is no different than bargaining to take a contribution deduction early. To do it you must pay the price."

What Sunley and others in his camp are saying is that this analogy to a contribution deduction 5 years later simply doesn't fit the cases they are talking about. What they emphasize is that in their cases the delayed expenditure is essentially related to the original income. "You can't have one without the other." They conclude that unlike the delayed contribution case, if the $100 cost in year 6 is something like the cost of fulfilling a service contract sold in year 1, then some of the cost should be deducted in year 1 and the taxpayer should still get the full deduction.

THE NEUTRALITY ARGUMENT

I think that the position that the service contract case is different because of the special connection between receipt in year 1 and the cost in year 6 is appealing but one should still ask "why does this connection make a difference?"

The opponents of the Treasury position defend the proposition "connection make a difference" by relying on the eminently sound principle of tax neutrality. To relate their argument to our highly simplified example, I continue my assumption of a service contract but I emphasize that there are selling costs of $20 which are incurred in year 1 simply to bring this contract into existence.

The neutrality argument goes this way. If we had no income tax at all, the current cost of fulfilling a contract to pay $100 in 10 years is $62. (This is $100 discounted by the before tax interest rate of 10% for 5 years. In this no tax world $62 of the sale proceeds could be put aside in a bank account to grow at 10% a year and it would be $100, in 10 years.)

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[1] We don't discuss a method #4 which would allow a deduction in year 1 of the full undiscounted $100. This was provided by Section 462 in the 1954 Act. This is even better for the taxpayer than #3 and is clearly too generous. We have enough of an issue by examining the case for #3.

[2] At this writing I am only aware of prior Treasury testimony on this subject, esp. with regard to mine reclamation. If Treasury adopts a different position in the hearing I will deal with it in oral testimony.

In this no tax world incurring $20 to sell our service contract produces a net profit of $16 ($98 – 62 = 36; 36 – 20 = 16).

The neutrality principle says that if two business ventures are equally profitable before tax, they should be equally profitable after tax. In other words the tax law should cut down profits uniformly.

It is easy to show in this simplified case that our original method #3 is the only one that meets the neutrality test. Using method #3 under a 50% income tax the service contract sale would report a first year profit of $16 (98 – 62 – 20), tax would be $8 and the seller would have $8 after tax to spend on beer and skittles. Thereafter everything washes out. The $62 could be put in a bank to earn 10% a year; the reserve increase each year would be exactly 10% so there would be no further tax and no further profit or loss. In year 6 the whole bank account and all the accumulated interest would exactly equal the obligation.

Under Method #3 the tax law hits the service contract sale exactly as hard as it hits the sale of the pair of shoes. Both report first year profit of $16 and there are no further tax consequences.

It is clear that applying Method #2 or Method #1 to delayed cost situations would have no effect on the sale of shoes, but would be more burdensome on the sale of the service contract; therefore these methods are unneutral against situations involving delayed costs.

(In our particular case, if the taxpayer was allowed in year 1 only a one time deduction of $78, it would be necessary to put the whole $78 in the bank to meet a $100 obligation in 5 years because the interest is now taxable. (Remember Method #2 allows no further deductions.) In this illustration the taxpayer is over taxed by exactly $8. There is nothing left for beer and skittles.)

I conclude that the Treasury argument in its testimony on mine reclamation expenses is seriously flawed. In principle, there should be full deduction of the estimated future costs related to current income and some part of this deduction (based on discounting at a before tax interest rate) should be allowed before the occurence of the future costs.

PROPERTY AND CASUALTY INSURANCE RESERVES

I understand that it is only tangential to the current topic but it should be recorded here that a somewhat similar issue has been discussed in the matter of the estimated loss reserve of property and casualty companies.

In prior testimony the Treasury introduced arguments quite similar to the arguments used on mine reclamation to argue that the estimated loss reserve of property and casualty insurance companies should be discounted. (Presently they are not discounted.) Since my conclusion that Method #3 is correct and #3 involves discounting, you would think that I would endorse the Treasury testimony on property-casualty. In fact, I did agree with that testimony for a long time but I have been convinced (without talking to people in the property/casualty field) that there is an important, unique problem here, which argues against discounting property/casualty loss reserves. Present law allows the property/casualty company to add to the reserve the full undiscounted estimated amount of the loss when the loss occurs, even if it will not be paid for several years. This lack of discounting is an obvious benefit to the insurance company.

The justification for this benefit is that there is an exactly equivalent disadvantage to the insured. A company that has a fire loss $100 this year and gets compensated at $100 in a few years later is not getting full compensation at the time of the fire. The then current value of the future compensation is say, $85. In approximately competitive markets this advantage to the insurer—not discounting the reserve—should work out as reducing the price of insurance which passes the benefit on to the insured for whom the undiscounted future compensation was used to cancel the loss deduction.

This is a good case where two wrongs come out about as right as we can get. Consider an alternative: we could insist on discounting estimated losses for the insurance company and we could change the rule in the present income tax regulations 1.165–1(d)(3) which provides that if there is an expectation of ultimate insurance compensation at the time a loss occurs, there is no loss deduction until the claim is settled. You could let the insured deduct his estimated loss less the current discounted value of the compensation. In practice this would not be as workable as present law because it would have all taxpayers and their agents getting into the business of estimating and discounting future loss claims. All this can operate much better if you let all the estimation be handled, and audited in insurance companies,

where there is a good deal of evidence on how to estimate, and skip the discounting complication on both sides.

ZIn the particular respect of whether or not to discount future loses in property/casualty insurance, no change of prsent law should be made.[3]

CONCLUDING REMARK

This statement is already long. I will add only that I recognize that there are very considerable practical problems connected with estimating expenses that will occur some time in the future. When you get to very specific legislation to allow reserves for estimated expenses it does seem to me that in some cases you will decide that the evidence on which to make and to audit estimates is very poor and that we would do well to limit the reserve method for now to some readily estimateable cases. I have not researched this point. What I can tell you is that my analysis of the problem leads to the conclusion that a reserve with full deduction, Method #3, is appropriate in cases where decent estimates of future costs related to current income can be made.

Chairman RANGEL. You were with the Joint Committee on Taxation when the Congress enacted I.R.C. section 462 which was subsequently repealed, and now many of the proposals are now asking us to go back to where we were in 1954, do you see any differences in the proposals that you are making today in the old one?

Mr. BRANNON. I would like to mention two things there.

I think the Treasury history of that occasion was somewhat wrong. The big problem that the Congress focused on in 1955 was one of transition; 452 and 462 applied to a broad range of cases such as my service contracts, guarantees, et cetera., and the law said in effect in 1955, you can take a deduction on the new service contracts you go into, and also in that year you will be taking deductions for fulfilling the service contracts that you entered in 1954 and 1953 and 1952. So in that one year you get this big combination of deductions, and so that was the source of this dramatic revenue loss.

We got into a good deal of discussion about various ways to handle that transition. I have not heard that problem discussed today at all. That is one of the transitions that relates to Mr. Lewis' advice. You really have to look at these things. Beyond that in 1955 we did not think about this time value of money. We were putting in the full amount of the expected deduction, and that was wrong. We had that too high.

Chairman RANGEL. Mr. Gibbons.

Mr. GIBBONS. Mr. Brannon, have you looked at my nuclear decommissioning bill?

Mr. BRANNON. No, sir, I have not.

Mr. GIBBONS. Good, I will not ask you any questions about it, then.

Thank you.

Chairman RANGEL. Let me thank our three panelists for the contribution that you have made. I invite you to monitor our deliberation and to offer the type of assistance which obviously we will need in order to finalize our approach to the full committee.

Thank you for your patience.

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[3] It can be noted that in life insurance the principle has been long established that discounted reserve accounting with full deduction is appropriate. The reserve interest rate is in principle a before tax rate but selecting thc is complicated by (1) the need to project far out in time; (2) the existence of state law reserve requirements; and (3) the existence of cash values. These details have ben explored in connection with other legislation.

The next panel is Don Kiefer, specialist in public finance from the Library of Congress; from Edison Electric Institute, Al Noftz, and David Sweetland, manager, North Attleboro (Mass.) Electric Department, accompanied by Frances Francis, counsel.

STATEMENT OF DONALD W. KIEFER, SPECIALIST IN PUBLIC FINANCE, ECONOMICS DIVISION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Mr. KIEFER. My name is Donald W. Kiefer. I am a specialist in public finance in the Economics Division of the Congressional Research Service in the Library of Congress. I have recently completed a study of the economic effects of Federal tax treatment of nuclear powerplant decommissioning costs, a copy of which will be attached to my full statement for the record. I wish to thank the subcommittee for the invitation to appear before you today to summarize the results of this study.

The cost of decommissioning is a capital cost associated with the production of electricity by the nuclear powerplant. That is an important point, one that was emphasized by Mr. Sunley in his testimony. We are talking about a capital cost as opposed to an operating cost. This cost must be paid by the customers who purchase the electricity produced by the nuclear powerplant. Currently, actual decommissioning costs at the time they are experienced are allowed as tax deductions, but amounts collected in anticipation of the costs are treated as taxable income.

The present tax treatment of decommissioning costs would be consistent with a tax system based on expensing; that is, the costs are deducted as they are expended rather than being spread over the life of the capital asset—as in a system of depreciation. In a tax system based on depreciation of capital assets, consistent treatment of negative salvage value would allow a series of deductions for the future capital cost over the life of the asset. If these deductions are not allowed, then the negative salvage value investment is penalized. For example, estimates in my study indicate that under current tax rules the effective tax rate on investment in a nuclear powerplant is approximately 20.8 percent; this is about three-tenths of a percent higher than the effective tax rate on an otherwise similar investment without negative salvage value.

My conclusions come from an analysis similar to Mr. Sunley's. The analysis looks at the economic effects over the life of the investment based on an internal rate of return concept and looks at how the capital expenditure should be treated within this context.

Some observers would argue, however, that the tax treatment of decommissioning costs should not be considered in isolation from other aspects of the tax treatment of nuclear powerplants. Specifically, under the ACRS depreciation rules, nuclear powerplants are depreciated over a 10-year period, whereas other public utility property which is equally long-lived must be depreciated over a 15-year period. My estimates indicate that the advantage of 10-year depreciation for nuclear powerplants is far greater than the disadvantage associated with current tax treatment of decommissioning costs.

However, if the current tax treatment of nuclear powerplants is regarded as appropriate in all regards except for the treatment of decommissioning costs, then, as mentioned above, the current treatment of these costs can be shown to impose a tax penalty. This penalty is extremely small. One policy question is whether the penalty is large enough to merit policy revision in light of other much larger differences in effective tax rates under our Tax Code. Nonetheless, it is a penalty and it has real effects; utility customers must pay more to cover the cost of decommissioning nuclear powerplants than if the tax penalty did not exist.

The most direct approach to eliminating this penalty, and the one most consistent with the structure of the Tax Code, would be to allow specified deductions for decommissioning costs over the life of the nuclear plant, much like depreciation deductions.

The primary disadvantage of providing specified deductions is that it would be difficult to know the actual appropriate amount to allow as a deduction for decommissioning costs.

A second policy approach to offsetting the penalty resulting from present tax treatment of decommissioning costs would be to allow deductions based on the actual additions to reserves for funding decommissioning. This is the approach which would be implemented by H.R. 2820.

If allowing deductions for additions to the decommissioning reserve would achieve roughly the correct economic result, then the amount of the allowable deduction would not have to be specified by the tax authorities, thus avoiding the necessity of the Congress and the Treasury dealing directly with the uncertainty surrounding decommissioning costs.

There are at least two problems associated with this approach to allowing the tax deductions, however. First, different utilities use different funding methods to provide for the future decommissioning cost. These different funding methods yield substantially different annual charges for decommissioning, even if the projected decommissioning cost is identical. Negative salvage value depreciation, which is the most common decommissioning funding method, produces decommissioning charges which substantially exceed the sinking fund methods because it is based on a straight-line amortization of the projected decommissioning cost. Thus, allowing tax deduction of amounts based on the annual additions to decommissioning reserves would provide substantially different levels of tax benefits to different utilities and their customers depending on which funding method is being used.

The second problem is that under all of the funding methods the additions to decommissioning reserves substantially exceed the size of the tax deduction necessary to offset the penalty which results from current tax treatment. Thus, allowing a full deduction for these reserve additions would entail providing a tax subsidy for decommissioning costs, in the sense that the nuclear powerplant investment would be treated more favorably than other investments without negative salvage values. My results suggest that allowing deduction of between one-fourth and one-half of annual reserve additions would, on average, approximate the appropriate deduction for the sinking fund financing methods.

To avoid providing inappropriately large benefits to some utilities, the availability of the deduction may have to be restricted to only those reserves which operate on a sinking fund basis. Alternatively, deductions for utilities which use negative salvage value depreciation could be limited to amounts which would be deducted under a sinking fund approach; however, this would increase the administrative difficulties and partly eliminate the advantage of relying on reserve contributions to determine the decommissioning deduction.

At the end of my prepared statement I talk about the specific problem of New England utilities which are single-asset companies. The Treasury is suggesting an extended carryback period for the losses associated with decommissioning costs which would take care of these companies' problems.

Chairman RANGEL. Thank you, Mr. Kiefer.

[The prepared statement follows:]

STATEMENT OF DONALD W. KIEFER, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

My name is Donald W. Kiefer. I am a specialist in public finance in the Economics Division of the Congressional Research Service of the Library of Congress. I have recently completed a study of the economic effects of Federal tax treatment of nuclear power plant decommissioning costs, a copy of which will be attached to my full statement for the record. I wish to thank the subcommittee for the invitation to appear before you today to summarize the results of this study.

As of January 1983 (the last date for which I have information) there were 73 nuclear power plants in commercial operation in the United States, and another 69 which were in various stages of construction, in preliminary operation, or inoperative. Unlike most other types of industrial or commercial structures, a nuclear power plant must be decommissioned; that is, the radioactivity of the power plant site must be reduced to a level considered safe for unrestricted use.

While small experimental or demonstration nuclear reactors have previously been decommissioned, no large commercial reactor has been, and there are many uncertainties surrounding the procedures and their costs. The Nuclear Regulatory Commission (NRC) has identified three potential procedures for decommissioning. The time required for carrying out these procedures ranges from a few years, for immediate dismantlement and decontamination, to over 100 years for a procedure labelled ENTOMB, which involves encasing the nuclear plant in concrete and leaving it until its radioactivity declines to a low level before dismantlement. Cost estimates for these procedures vary substantially, but range up to $146 million in 1982 dollars for a large nuclear plant. With the forecasted inflation between now and the time the larger plants are expected to be decommissioned, the cost could easily exceed one-half billion dollars per plant.

The cost of decommissioniong is a capital cost associated with the production of electricity by the nuclear power plant; it must be paid by the consumers who purchase the electricity. Because the costs are large, the Federal tax treatment of these costs has significant implications for the level of electric utility rates. Currently, actual decommissioning costs at the time they are experienced are allowed as tax deductions, but amounts collected in anticipation of the costs are treated as taxable income.

The present tax treatment of decommissioning costs would be consistent with a tax system based on expensing; that is, the costs are deducted as they are expended rather than being spread over the life of the capital asset (as in a system of depreciation). If the U.S. tax system were based on a system of expensing, then the current tax treatment of decommissioning costs would be consistent with this structure. It is shown in an appendix to my study that in a tax system based on depreciation of capital assets, consistent treatment of negative salvage value would allow a series of deductions for the future capital cost over the life of the asset. If these deductions are not allowed, then the negative salvage value investment is penalized, in the sense that it will have a higher effective tax rate than a similar investment without the negative salvage value. For example, estimates in my study indicate that under current tax rules the effective tax rate on investment in a nuclear power plant is

approximately 20.8 percent; this is about three-tenths of a percent higher than the effective tax rate on an otherwise similar investment without a negative salvage value. (These effective tax rates are based on comparison of before-tax and after-tax internal rates of return over the life of the investment; they are not based on cash flow for a single year, as are the effective tax rates frequently published for various industries.)

Some observers would argue, however, that the tax treatment of decommissioning costs should not be considered in isolation from other aspects of the tax treatment of nuclear power plants. Specifically under the ACRS depreciation rules nuclear power plants are depreciated over a 10-year period, whereas other public utility property which is equally long-lived must be depreciated over a 15-year period. My estimates indicate that an investment which is similar to a nuclear power plant, but has no negative salvage value and must use the 15-year ACRS depreciation period, would have an effective tax rate of nearly 28 percent, compared to the effective rate of under 21 percent on the nuclear power plant investment. This comparison suggests that the advantage of 10-year depreciation for nuclear power plants is far greater than the disadvantage associated with current tax treatment of decommissioning costs. From this perspective, therefore, nuclear power plants would be regarded as already being treated more favorably than other comparable investments under the tax code, so no correction of the treatment of decommissioning costs would be justified.

If this view does not prevail and the current tax treatment of nuclear power plants is regarded as appropriate in all regards except for the treatment of decommissioning costs, then, as mentioned above, the current treatment of these costs can be shown to impose a tax penalty. This penalty is extremely small. One policy question is whether the penalty is large enough to merit policy revision in light of other much larger differences in effective tax rates under our tax code. Nonetheless, it is a penalty and it has real effects; utility customers must pay more to cover the cost of decommissioning nuclear power plants than if the tax penalty did not exist.

The most direct approach to eliminating this penalty, and the one most consistent with the structure of the tax code, would be to allow specified deductions for decommissioning costs over the life of the nuclear plant, much like depreciation deductions. To be consistent with the actual economic effects of the future decommissioning costs, the deductions should be small early in the plant's life and grow larger late in its life, the opposite pattern from accelerated depreciation. It would be possible to use other patterns of deductions, however, and achieve the same economic result over the life of the plant. For example, a level deduction of a portion of the decommissioning cost could be allowed over the life of the plant, with the remainder of the cost deductible in the year of decommissioning.

The primary disadvantage of providing specified deductions is that it would be difficult to know the actual appropriate amount to allow as a deduction for decommissioning costs. The appropriate amount for the deduction depends on the expected future cost of decommissioning, the time period over which the decommissioning will occur, the inflation rate in costs of decommissioning, and rates of interest from the present to the decommissioning period.

The size of the appropriate decommissioning deduction could vary significantly from one utility to another. Furthermore, each of the factors affecting decommissioning costs is highly uncertain, which implies that estimates of the appropriate deduction will change in the future as expectations and cost estimates change.

A second policy approach to offsetting the penalty resulting from present tax treatment of decommissioning costs would be to allow deductions based on the actual additions to reserves for funding decommissioning. This is the approach which would be implemented by H.R. 2820. It may seem initially that these payments should be deductible by the company under the present structure of the tax code, since these are the company's actual outlays to pay for decommissioning. But the reserve mechanism is a financing scheme much like a mortgage or a bond sale which is used to finance the purchase of a factory. The depreciation deductions on a factory (or utility plant) do not depend on the pattern of repayment of the principal of the mortgage or of retirement of the bonds. Rather, the pattern of depreciation deductions is established so as to have the desired economic effect in determining the effective tax rate on the investment. Similarly, the economically appropriate pattern of tax deductions for the future decommissioning cost does not depend on the particular financing method used to provide for the cost.

Nonetheless, if allowing deductions for additions to the decommissioning reserve would achieve roughly the correct economic result (i.e., effective tax rate), then there could be an advantage to this approach. The amount of the allowable deduction would not have to be specified by the tax authorities, thus avoiding the necessi-

ty of the Congress and the Treasury dealing directly with the uncertainty surrounding decommissioning costs. The deduction would be determined by the calculations made by the utilities and their regulators in establishing the decommissioning funding procedure. The same factors which determine the economically appropriate amount for the tax deduction for decommissioning costs also determine the amounts which must be set aside in a reserve to fund the future decommissioning cost.

There are at least two problems associated with this approach to allowing the tax deductions, however, first, different utilities use different funding methods to provide for the future decommissioning cost. These different funding methods yield substantially different annual charges for decommissioning, even if the projected decommissioning cost is idenential, Roughly speaking, the funding methods may be grouped into three categories: internal sinking fund, external sinking fund, and negative salvage value depreciation. An external sinking fund, while providing the greatest assurance of the availability of the decommissioning funds when required, necessitates an annual addition to the decommissioning reserve which may be significantly higher than that for an internal sinking fund because the rates of return available on market securities are generally lower than the utility's rate of return (which is earned on an internal reserve). Negative salvage value depreciation, which is the most common decommissioning funding method, produces decommissioning charges which substantially exceed the sinking fund methods because it is based on a strainghtline amortization of the projected decommissioning cost. Thus, allowing tax deduction of amounts based on the annual additions to decommissioning reserves would provide substantially different levels of tax benefits to different utilities and their customers depending on which funding method is being used.

The second problem associated with allowing tax deductions for additions to decommissioning reserves is that, according to estimates in my study, under all of the funding methods the additions to decommissioning reserves substantially exceed the size of the tax deduction necessary to offset the penalty which results from current tax treatment. Thus, allowing a full deduction for these reserve additions would entail providing a tax subsidy for decommissioning costs, in the sense that the nuclear power plant investment would be treated more favorably than other investments without negative salvage values. To gain the advantages of relying on the decommissioning funding mechanism to determine the amount of the allowable tax deduction, it may be possible to allow a deduction for a fraction of the reserve addition. My results suggest that allowing deduction of between one-fourth and one-half of annual reserve additions would, on average, approximate the appropriate deduction for the sinking fund financing methods.

To avoid providing inappropriately large benefits to some utilities, the availability of the deduction may have to be restricted to only those reserves which operate on a sinking fund basis. Alternatively, deductions for utilities which use negative salvage value depreciation could be limited to amounts which would be deducted under a sinking fund approach; however, this would increase the administrative difficulties and partly eliminate the advantage of relying on reserve contributions to determine the decommissioning deduction.

One final issue regarding tax treatment of decommissioning costs should be mentioned. There are four utilities in New England—Maine Yankee Atomic Power Company, Yankee Atomic Electric Company in Massachusetts, Vermont Yankee Nuclear Power Corporation, and Connecticut Yankee Atomic Power Corporation—which were created specifically to own and operate nuclear plants. These companies own no other assets and are not expected to continue in operation once their nuclear plants have served their useful lives and are dismantled. Once the nuclear plants owned by these companies go out of service, there will no longer be any taxable income against which to deduct the costs of decommissioning. While net operating losses may be carried back 3 years to offset earlier taxable income, even the immediate dismantlement of a nuclear plant is likely to take 4 years or more, and, in any event, the taxable income in the last years of the plant's operation is not likely to be sufficient to absorb all of the decommissioning costs. For single-asset nuclear power companies, therefore, the current tax rules will likely have the effect of denying a deduction for some or most of the decommissioning costs when they are actually experienced.

The policy change options discussed above would relieve this problem by providing some deductions over the life of the plant while taxable income is being earned. However, the policy changes would not put the single-asset utility in a situation comparable to other utilities because the single-asset company still would be unable to utilize the deduction at the time of decommissioning for costs which had not previously been deducted. The most direct policy approach to solving this problem would be to allow an extended carryback of net operating losses experienced by elec-

tric utilities resulting from the costs of decommissioning nuclear plants. A potential problem with the extended loss carryback approach to decommissioning costs, however, is that the carryback period allowed may have to be very long. It is uncertain whether carryback periods of 40 to 100 years or more are administratively feasible.

[Report No. 84-28E]

Economic Analysis of the Tax Treatment of Nuclear Power Plant Decommissioning Costs

(By Donald W. Kiefer, Specialist in Public Finance, Economics Division, Congressional Research Service, Library of Congress)

ABSTRACT

This report provides an economic analysis of the tax treatment of nuclear power plant decommissioning costs. The policies discussed include current tax treatment and the policy revisions which would be enacted by H.R. 2820. The report discusses the relevant economic theory and provides simulations of the effects of the alternative policies on utility rates charged to customers, Federal tax revenues, and cash flow of the utility companies.

I. INTRODUCTION AND OVERVIEW

At the end of the operating life of a nuclear power plant it must be decommissioned; that is, the radioactivity of the power plant site must be reduced to a level considered safe for unrestricted use. Decommissioning is expensive--estimates range up to $146 million (in 1982 dollars) per nuclear plant--so the treatment of these costs under the Federal income tax has important consequences for electric utilities, utility customers and Federal tax collections. Under current tax treatment, decommissioning costs are deductible only when the decommissioning actually occurs.

The current tax treatment of decommissioning costs would be changed by H.R 2820, introduced by Representative Gibbons. This bill would allow public utilities to take current tax deductions for amounts added to reserves for nuclear power plant decommissioning costs to the extent that the regulatory commission permits the amounts to be included as a cost of service for rate-making purposes.

This report provides an anlysis of the economic issues surrounding Federal income tax treatment of nuclear power plant decommissioning costs and of the economic effects of alternative tax treatments. The report does not address the legal issues involved in the topic. Section II of the report provides background on nuclear plant decommissioning methods and costs, funding

mechanisms, and tax treatment. Section III provides the theoretical economic framework for consideration of the issue. Section IV is an analysis of the effects of current tax treatment of decommissioning costs and H.R. 2820 on utility rates, utility cash flows, and tax revenues. Section V discusses the policy implications, which may be summarized briefly as follows:

- Compared to other long-lived electric generating plants, nuclear power plants receive favorable treatment under the Federal income tax. This favorable treatment results from the fact that nuclear plants qualify for 10-year ACRS depreciation, whereas other long-lived generating plants are in the 15-year property ACRS class. This difference in depreciation periods reduces the effective tax rate on nuclear plants by about seven percentage points.

- Considered in isolation from other aspects of taxation of nuclear plants, the current tax treatment of nuclear power plant decommissioning costs raises the effective tax rate on investments in these plants (compared to the tax treatment of investments which do not have negative salvage values). The penalty associated with current tax treatment of decommissioning costs is small: less than one-half percentage point in terms of effective tax rates.

- If the tax penalty resulting from current treatment of decommissioning costs is to be eliminated, the most direct approach, and the one most consistent with the structure of the tax code, would be to allow specified deductions for decommissioning costs over the life of the nuclear plant much like depreciation deductions. Because the tax penalty is small, the annual deductions would also be small, with the portion of decommissioning costs not deducted during the life of the plant to be deducted at the time of decommissioning. The primary disadvantage of this approach is that it would be difficult to know the appropriate amount to allow as deductions for decommissioning costs because of the uncertainties surrounding the amounts and timing of these future costs.

- A second policy approach would be to allow deductions based on the actual additions to reserves established by the utilities for funding decommissioning, the approach of H.R. 2820. This approach would rely on estimates of decommissioning costs by the utilities and their regulatory agencies to determine the amount of the tax deduction. However, under all known funding methods used to provide decommissioning revenues, the annual reserve additions substantially exceed the size of the tax deduction necessary to offset the penalty associated with current tax treatment of decommissioning costs. Allowing full deductibility, therefore, would provide a tax subsidy for decommissioning costs. As an alternative, it may be possible to allow a deduction for a fraction of reserve additions.

° The negative salvage value depreciation method of funding decommissioning costs yields annual decommissioning charges which substantially exceed those associated with sinking fund methods. Thus, if a deduction for decommissioning reserve additions is to be allowed, to avoid providing inappropriately large benefits to some utilities, the availability of the deduction may have to be restricted to only those reserves which operate on a sinking find basis, or alternatively, the deduction may have to be limited to amounts which would be deducted under a sinking fund approach.

° A few public utilities which operate nuclear plants are single-asset companies which will not continue to have income beyond the life of the power plant. For these companies current tax rules, in effect, deny a deduction for some or most decommissioning costs. The policies referred to above would relieve this problem somewhat, but would not eliminate it. The most direct policy approach to solving this problem would be to allow an extended carryback of net operating losses experienced by electric utilities resulting from the costs of decommissioning nuclear power plants.

II. BACKGROUND: NUCLEAR POWER PLANT DECOMMISSIONING METHODS AND COSTS, FUNDING MECHANISMS, AND TAX TREATMENT

As of January 1983, there were 73 nuclear power plants in commercial operation in the United States, another five with operating licenses, five which were shut down and an additional 59 in various stages of construction. 1/ The first commercial nuclear electric generating units went into service in the early 1960s and have now reached or are approaching the end of their useful lives. Unlike other types of industrial or commercial structures, a nuclear power plant may not merely be torn down or abandoned when it has completed its useful life. A nuclear plant must be decommissioned; that is, the radioactivity of the power plant site must be reduced to a level considered safe for unrestricted use.

While small experimental or demonstration nuclear reactors have previously been decommissioned, no large commercial reactor has been, and there are many uncertainties surrounding the procedures and their costs. The Nuclear Regulatory Commission (NRC) has identified three potential procedures for decommissioning. One, labeled DECON by the NRC, involves immediate decontamination and dismantlement upon termination of the reactor's operation. The second procedure, termed SAFSTOR, involves placing the shut down reactor into protective storage for a period lasting from 30 to 100 years and then dismantling the reactor and decontaminating the site. The advantage of this procedure is

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1/ Info, Atomic Industrial Forum, Inc., January 1983.

that during the storage period the radioactivity of the elements with short half-lives will decrease to a low level, reducing the cost of the eventual decontamination of the site. The third decommissioning procedure, called ENTOMB, involves immediately removing radioactive materials with very long half-lives and then encasing the nuclear plant, for example in concrete, and retaining it in that state for a lengthy period, probably 100-years or more, until the remaining radioactivity decreases to an acceptable level.

Estimated costs, in 1982 dollars, for decommissioning a reference nuclear generating reactor 2/ range from $28.4 million to $145.8 million for DECON. 3/ For SAFSTOR the estimated costs of preparing the reactor for storage range from $3.5 million to $23.9 million, the costs of surveillance and security during the storage period are estimated at between $0.1 million and $0.2 million per year, and the eventual cost of dismantlement is estimated to equal between 60 percent and 82 percent of dismantlement under DECON. Estimates of the costs of preparation for storage under ENTOMB range from $7.8 million to $49.0 million, and the annual costs during the storage period are estimated to be somewhat less than under SAFSTOR. While the DECON procedure is the most expensive, it has the advantage of quickly releasing the reactor site for other uses. The cost estimates for SAFSTOR and ENTOMB do not include any factor to reflect lost output resulting from inability to use the reactor site for other purposes during the storage

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2/ The assumed sizes of reactors used for the estimates are a 1,155 MW boiling water reactor and a 1,175 MW pressurized water reactor.

3/ The cost estimates in this paragraph are from Burns, Robert E., et. al., Funding Nuclear Power Plant Decommissioning, The National Regulatory Research Institute, October, 1982, Chapter 4. The document cites cost estimates from several studies performed by utilities and consultants.

period. The wide range of these estimates makes it clear that the eventual cost of decommissioning nuclear power plants is highly uncertain. While some of the earlier commercial reactors are approaching their decommissioning, it will be several years before any of the newer, larger nuclear plants are decommissioned. 4/ Until experience is gained with the larger reactors, the uncertainty surrounding the cost of these procedures is likely to remain.

The nontrivial costs associated with decommissioning raise the question of how these expenses will be provided for. One option, of course, would be to wait until the expenses are incurred and charge utility customers at that time to recover the costs. There are two problems with this approach. First, while the NRC has not promulgated its final regulations, it requires some assurance of available funds for decommissioning because of the public safety aspects of the problem. The NRC requirements appear to be met at present by some form of funding over the life of the nuclear power plant combined with insurance to cover liabilities in the event of the need for premature decommissioning. 5/ Second, the logic of the regulatory framework within which utilities operate dictates that utility customers who consume the power generated by a nuclear plant should bear all of the costs asssociated with providing the power, including the decommissioning costs. These considerations suggest some funding method over the life of the plant to pay for the eventual decommissioning costs.

4/ First Nuclear Plant, Grown Old, Prepares to Meet its Wrecker, Wall Street Journal, December 16, 1983, p. 1, 15.

5/ Wood, Robert S. Funding for Reactor Decommissioning: The NRC Perspective, Nuclear News, December, 1981, pp. 85-88.

While a variety of funding mechanisms is possible, only three general funding methods are known to be in use by public utilities (complete information on this subject is not readily available). There is wide variation in specific application of each of these funding methods, however. The majority of utilities with nuclear plants are providing for the estimated decommissioning costs through some form of negative salvage value depreciation. 6/ Under this procedure, the annual depreciation charge for financial and ratemaking purposes (which is nearly universally based on the straight line method) is based on the original cost of the nuclear plant plus the estimated costs of decommissioning the plant (the negative salvage value). Using this method the utility "recovers" the decommissioning costs over the life of the plant as internally generated funds. Under this system the decommissioning funds are not segregated from the utility's other funds and they are invested in the utility's assets, thus reducing the utility's requirements for external financing. At the time of decommissioning the cost would be paid using internal funds built up over the life of the plant which would be replaced by new external funds. In effect, the utility pays for decommissioning through the sale of new stocks and bonds. As will be seen in section IV, this funding method offers certain advantages to both the utility companies and customers, but it also provides less assurance of funding availability because the actual decommissioning funds must be raised externally when required.

6/ 1982 Survey of Financial Reporting and Accounting Developments in the Public Utility Industry, Price Waterhouse, 1982, p. 30.

The second method of providing for nuclear power plant decommissioning costs currently in use is through an external sinking fund. This funding method offers greater assurance of the availability of funds when required for decommissioning, but may be less beneficial to the utilities and their customers. Under this procedure the utility makes deposits in an external fund, managed by a fiduciary (or, in some cases, the State Treasurer's Office), in amounts determined so that the deposits and accrued interest will accumulate to equal the expected cost of decommissioning. A separate charge is included in the utility's cost of service to cover the deposits. Under this procedure the internal flow of funds of the utility and the financing of its assets are not affected by the decommissioning funding mechanism.

The third decommissioning financing mechanism is an internal sinking fund. This procedure combines some elements of the first two. As under the external sinking fund, the utility's customers pay a charge which funds a reserve for decommissioning; the charge is determined so deposits and accrued interest on the reserve will pay the projected decommissioning cost. Like negative salvage value depreciation, however, the reserve is internal; it is maintained within the company and the funds are invested in the utility's assets. 7/ The internal sinking fund may have an advantage over an external fund because the company's internal rate of return is probably

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7/ Strictly speaking, the description here is of an "unfunded" internal reserve. Some companies use "funded" internal reserves, which means the reserve is managed by the company, as opposed to a third party, but is invested in market securities rather than in the company. For present purposes this type of fund will be regarded as external, since it does not provide cash flow to the utility.

higher than can be earned on an outside fund, thus reducing the annual charge required to fund the reserve. On the other hand, the internal reserve provides less funding assurance than the external fund and is riskier in a financial sense because all of the reserve's assets are invested in only one company.

Most public utilities with nuclear power plants are funding decommissioning costs through one of these methods, however, a few utilities with nuclear plants do not currently make any provision for decommissioning. In some cases the reason for no current provision is that the "costs are not yet determinable" and in others the reason is that a charge for decommissioning costs has not been authorized by the utility regulatory commission. 8/

While most public utilities accrue decommissioning costs as a current expense during the life of the nuclear plant, the Internal Revenue Service (IRS) does not allow these amounts as deductions for purposes of the Federal income tax. The IRS has rejected the deduction of accrued costs over the lives of the assets for nuclear power plant decommissioning costs, the costs of removing offshore drilling platforms, and the costs of reclaiming the land used for strip mining, all which raise similar issues. For tax purposes, actual decommissioning costs at the time they are experienced are allowed as deductions, but amounts collected in anticipation of the costs are treated as taxable income. If decommissioning is funded by a sinking fund, the interest on the fund is also regarded to be taxable by the IRS. The IRS position is

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8/ Price Waterhouse, op. cit., p. 30.

disputed by some taxpayers and lawyers 9/ and the interpretation of applicable law has not been resolved by the courts. For this reason, this report will use "current tax rules" or "treatment" to refer to IRS interpretation and enforcement rather than referring to "current tax law", which remains to be interpreted definitively.

There is one circumstance in which tax deduction of decommissioning costs may be effectively precluded under current tax rules. Some nuclear generating facilities are owned by utility companies which were created specifically to own and operate the nuclear plants. These companies own no other assets and are not expected to continue in operation once their nuclear plants have served their useful lives and are dismantled. These single-asset nuclear power generating companies are owned by groups of public utilities who purchase their power. For example, the Maine Yankee Atomic Power Company is a nuclear electric generating company which is owned by a group of eleven electric utilities headed by Central Maine Power Company. Yankee Atomic Electric Company, in Massachusets; Vermont Yankee Nuclear Power Corporation; and Connecticut Yankee Atomic Power Company are in similar situations. For these companies, the regulatory agencies have required, or are in the process of requiring, the use of the external sinking fund method of funding decommissioning costs to assure the availability of funds when required. After the nuclear plants owned by

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9/ A detailed legal discussion of the issues is provided in, Palmer, Stephen L., A Suggestion for Federal Tax Treatment of Accrued Nuclear Power Plant Decommissioning Expenses, Tax Lawyer, Spring, 1982, p. 779-797. Legal discussions of the general issue of tax treatment of deferred costs are provided in; Aidinoff, M. Bernard, and Benjamin B. Lopata, Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future, Tax Lawyer, Spring, 1980, p. 789-824; and the Committee on Taxation of the Association of the Bar of the City of New York, Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and The Time Value of Money, Tax Notes, August 29, 1983, p. 699-714.

these single-asset companies have served their useful lives, there will no longer be any taxable income against which to deduct the costs of decommissioning. While net operating losses may be carried back three years to offset earlier taxable income, even the immediate dismantlement of a nuclear plant is likely to take four years or more, and, in any event, the taxable income in the last years of the plant's operation is not likely to be sufficient to absorb all of the decommissioning costs. For single-asset nuclear power companies, therefore, the current tax rules will likely have the effect of denying a deduction for some or most of the decommissioning costs when they are actually experienced.

The current tax treatment of decommissioning costs would be changed by H.R. 2820, introduced by Representative Gibbons (reproduced in Appendix III). This bill would allow public utilities to take current tax deductions for amounts added to reserves for nuclear power plant decommissioning costs to the extent that the regulatory commission permits the amounts to be included as a cost of service for ratemaking purposes. The bill would not provide a tax deduction for the return earned on a sinking fund established to fund decommissioning costs. At the time of decommissioning the bill would specifically allow deduction of costs to the extent that they were funded prior to passage of the bill. With regard to costs funded after passage of the bill, deduction would be denied for amounts previously deducted when they were added to the decommissioning reserve, but amounts in excess of this would be deductible. 10/ Any amount in the decommissioning reserve which exceeds the actual cost of decommissioning would be taxable when taken back into income by the utility.

10/ While this is the intent, the language in the bill is somewhat unclear on this point; see new subsection 162 (J)(5) in the bill (reproduced in Appendix III).

III. THEORETICAL ISSUES: CAPITAL COST RECOVERY OF NUCLEAR POWER PLANT DECOMMISSIONING COSTS

The purpose of this section is to provide the theoretical economic framework within which the tax treatment of nuclear power plant decommissioning costs may be addressed; a more technical and detailed presentation of these issues is contained in appendix I.

The tax rules which apply to investment income determine the wedge between the pre-tax and after-tax rates of return on investment. In a theorectically pure income tax the rate of return received by an investor would be reduced by the percentage of the statutory tax rate. For example, if the pre-tax rate of return is 10 percent and the tax rate is 40 percent, the after-tax rate of return would be six percent. In this example the "effective tax rate" is 40 percent; that is, the after-tax rate of return is 40 percent less than the pre-tax rate of return. In a theoretically pure consumption tax the effective tax rate on investment income is zero; that is, the after-tax rate of return is equal to the pre-tax rate of return. The consumption tax approach may be achieved, of course, by simply exempting investment income from taxation. Alternatively, the result may be achieved by a system of expensing all capital costs. It can be shown readily that a system of expensing results in a zero effective tax rate on investment income (see appendix I).

Either of these theoretically pure tax systems, if consistently applied to all types of investment, would be neutral in its effect on investment patterns. That is, investment capital would always flow to where it has the highest expected pre-tax rate of return because the effective tax rate on all investments

would be equal. Thus, the efficiency of the investment process would be preserved.

These two polar types of tax system--a theoretically pure income tax, and a consumption tax system which allows expensing of capital costs-- are ueful conceptual models in considering the tax treatment of nuclear power plant decommissioning costs. The present tax treatment of these costs is consistent with a system of expensing; that is the costs are deducted as they are expended rather than being spread over the life of the capital asset (as in a system of depreciation). If the U.S. tax system were based on a system of expensing, then the current tax treatment of decommissioning costs would preserve the effective tax rate on investment income under that system, namely zero.

Under a theoretically pure income tax, on the other hand, capital costs are not expensed but are deducted according to the pattern of "economic depreciation". Under economic depreciation the amount of tax depreciation allowed each year is the actual change in market value of the capital asset. Under this type of tax system deductions would be allowed for decommissioning costs each year over the life of the power plant. This can be understood most easily by considering the effect of the future decommissioning costs on the amount an investor would be willing to pay for the nuclear power plant each year during its life (assuming such a hypothetical transaction were feasible). At the begining of a power plant's operating life its value is less than it would otherwise be because of the necessity to decommission. That is, the hypothetical investor would be willing to pay less than otherwise for the plant because of the required large payment at the end of the investment. But this effect is relatively small initially because the decommissioning cost is far in the future and its discounted value is small.

The negative effect of the decommissioning cost on the power plant's value increases each year of the plant's life, however, because the required decommissioning payment becomes one year closer and is discounted less. Eventually, toward the end of the plant's life, the investor would have to be paid to be willing to take the power plant because the decommissioning cost would be a larger factor in determining its value than any remaining income. Under a system of economic depreciation the annual reduction in the value of the power plant attributable to the future decommissioning cost would be allowed as a tax deduction.

Thus, the present tax treatment of nuclear power plant decommissioning costs is consistent with a system of expensing, which would achieve a zero effective tax rate. The treatment is not consistent with a theoretically pure income tax allowing economic depreciation, which would achieve an effective tax rate equal to the statutory tax rate.

While expensing and economic depreciation are useful conceptual models for focusing the issues, the U.S. tax system conforms to neither model. Present tax rules allow an investment tax credit and a series of capital cost recovery deductions which are not neutral in their effects on different types of investment. For most types of investment the present tax system yields effective tax rates falling somewhere between zero and the statutory tax rate. 11/

The current tax treatment of capital investments does not conform to any known conceptual model, and therefore what standard should be used in

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11/ See Gravelle, Jane G. Capital Income Taxation and Efficiency in the Allocation of Investment. National Tax Journal, September 1983. p. 297-306, esp. tables 1 and 2.

judging the "correctness" or consistency of the tax treatment of a particular item within the system is unclear. However, the tax treatment of different investments may be compared to explore whether investments with a particular characteristic are being treated more or less favorably than "similar" investments without the characteristic.

Applying this standard requires identifying a "similar" investment to use as a benchmark, and the conclusions one draws from the comparison depend on the benchmark chosen. Calculations described in appendix I indicate that under current tax rules the effective tax rate on an investment in a nuclear power plant is approximately 20.8 percent. The estimates also indicate that a benchmark investment which is identical in all regards (including tax treatment) except that it has no decommissioning costs 12/ would have an effective tax rate of 20.5 percent. Thus, the penalty imposed by current tax treatment is extremely small. Nonetheless, the nuclear power plant investment has an effective tax rate which is slightly higher than the benchmark investment because the decommissioning cost is expensed.

Since the effective tax rate on the nuclear plant is between zero and the statutory tax rate, it is not surprising that the tax treatment of decommissioning costs required to equate the effective tax rates on the nuclear power plant and the benchmark investment is a treatment which falls somewhere between expensing and economic depreciation. Specifically, the decommissioning cost would have to be partially deducted over the life of the power plant. For ease of reference throughout the remainder of the paper, this partial deduction of

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12/ The bechmark investment also differs in the pre-tax cash flows required to provide the assumed after-tax rate of return. This is, of course, what leads to the difference in effective tax rates.

decommissioning costs will be referred to as the "equal treatment deduction". One way of providing the equal treatment deduction would be through the appropriate linear combination of expensing and economic depreciation; that is, a portion of the decommissioning cost would be deducted according to the pattern of economic depreciation over the life of the plant, and the remaining portion of the cost would be deducted at the time of decommissioning. Other patterns of deductions are also possible, however; for example, a level annual deduction over the life of the plant could be used to achieve an effective tax rate equal to that on the benchmark investment.

As stated earlier, however, the conclusions drawn from this type of comparison depend on the benchmark investment regarded to be appropriate. Some observers would argue that the tax treatment of decommissioning costs should not be considered in isolation from other aspects of the tax treatment of nuclear power plants. Specifically, under the ACRS depreciation rules nuclear power plants are depreciated over a 10-year period, whereas other public utility property which is equally long-lived must be depreciated over a 15-year period. Those who regard the shorter depreciation period for nuclear power plants as a special benefit would argue that the appropriate benchmark is an investment identical to the nuclear power plant investment except with a 15-year ACRS period and no decommissioning cost. Calculations in appendix I indicate such an investment would have an effective tax rate of 27.9 percent, compared to the effective rate of 20.8 percent on the nuclear power plant investment. This comparison suggests that the advantage of 10-year depreciation for nuclear power plants is far greater than the disadvantage associated with current tax treatment of decommissioning costs. It also serves to emphasize

the judgemental nature of decisions regarding appropriate tax treatment within the context of our present tax system.

To summarize the theoretical economic discussion, if the current tax treatment of nuclear power plant decommissioning costs is considered in isolation, then a case can be made that to be consistent with the treatment of other investments under the current tax system, a partial deduction for decommissioning costs should be allowed over the life of the nuclear plant. On the other hand, if the 10-year ACRS life for nuclear power plants is regarded as a special tax treatment to be included in the evaluation, then a case can be made that even including the treatment of decommissioning costs, the current tax treatment of nuclear power plants is more favorable than that of other comparable investments.

IV. SIMULATION ANALYSIS: THE EFFECTS OF CURRENT TAX TREATMENT OF NUCLEAR POWER PLANT DECOMMISSIONING COSTS AND H.R. 2820 ON UTILITY RATES, TAX REVENUES, AND UTILITY CASH FLOWS

This section provides an analysis of the effects of current tax treatment of nuclear power plant decommissioning costs and the tax policy changes in H.R. 2820 on utility revenue requirements (utility rates), Federal income tax liabilities of the utilities, and utility company cash flows. These effects are assessed by comparison to effects which would result from allowing the "equal treatment deduction" discussed in the previous section. In studying these effects, it is necessary to take into account the complex interrelationships among the alternative tax treatments, the decommissioning funding mechanism used by the utility, and the regulatory treatment of the utility. To capture these interrelationships, the analysis is conducted through simulation of the relevant variables over the life of a hypothetical nuclear power plant using a computer model described in Appendix II. It should be emphasized that the simulations are representative of the effects of the different funding methods and the treatments, but because of substantial variation in industry practices and regulatory treatment, they may not necessarily portray the effects for any particular company. The simulations require certain assumptions; the sensitivity of the simulation results to variation in these assumptions is discussed after the basic results have been presented.

For purposes of simulation, the nuclear power plant is assumed to have a 35-year useful life. The plant is assumed to be decommissioned during the 36th

year. A one-year decommissioning is unrealistic, but is assumed to simplify the analysis and to focus the evaluation on the effects of alternative tax policies during the life of the plant. The simulations do not include alternative decommissioning mehtods (i.e. SAFSTOR and ENTOMB) and therefore do not explore the effects of different tax policies on the costs of the decommissioning methods. 13/ The nuclear plant is assumed to have cost $1 billion to construct and to have an estimated decommissioning cost of $50 million stated in terms of dollars in the year it is placed in service. 14/ The inflation rate in decommissioning costs is assumed to equal seven percent over the life of the plant, leading to a nominal decommissioning cost of $571.2 million in the 36th year of the simulation. 15/ The general inflation rate over the simulation period is assumed to be 6 percent. The simulation assumes that the utility's decommissioning charges are based on the projected inflated cost of decommissioning, even though it is not clear that the full effects of inflation are allowed for in all cases in actual decommissioning charges being authorized by regulatory commissions and used by utilities. The simulation also assumes that all forecasts and expectations are, in fact, correct so that the actual inflation rate and cost of decommissioning are as predicted even though, in reality, much

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13/ Different tax policies do affect the relative costs of the alternative decommissioning methods. See: John S. Ferguson, The Capital Recovery Aspects of Decommissioning Power Reactors, Public Utilities Fortnightly, September 25, 1980, p. 34-42, especially Table II, p. 39.

14/ These figures are based on approximations stated in, Wood, Robert S., Funding for Reactor Decommissioning: The NRC Perspective, Nuclear News, December 1981, p. 86.

15/ This inflation rate is based roughly on the projected increase in the implicit price deflator for industrial structures during the period 1988 to 1995, as reported in: Data Resources, Inc., U.S. Long-Term Review, Summer, 1983, Table 8.3, p. 1.100.

uncertainty is associated with these variables. The utility company in the simulation is assumed to have a debt ratio of 50 percent, an embedded interest cost on debt of nine percent, and an allowed rate of return of 11 percent. 16/ The utility company is assumed to be subject to a 46 percent marginal Federal income tax rate (State or local taxes are not incorporated in the analysis). If the utility provides for decommissioning costs through an external sinking fund, the fund is assumed to be able to earn a ten percent rate of return if invested in taxable securities or an eight percent return if invested in tax-exempt securities. 17/

Using these assumptions the magnitude of the equal treatment deduction is estimated in Appendix I. Because the penalty imposed by the current tax treatment of decommissioning costs is small, so is the deduction required to offset it. If the deduction were to be allowed as a constant amount each year over the life of the power plant, it would have to equal approximately $454 thousand per year, with the remaining cost deducted at the time of decommissioning, to equate effective tax rates between the nuclear plant and a financially-similar investment without a negative salvage value. This pattern for the equal treatment deduction (a level annual deduction) is not unique, nor is it necesarily the most appropriate pattern. Because the equal treatment deduction could have a variety of patterns, its effects are not simulated, but the results from allowing the level annual deduction will be compared to the results of the other simulations.

16/ These figures are roughly consistent with data for electric utilities in 1981; see: Energy Information Administration, U.S. Department of Energy, Statistics of Privately Owned Electric Utilities, 1981 Annual (classes A and B) companies), June 1983, Table 4, p. 8, and Table 15, p. 16.

17/ These rates are based on the projected interest rates on new AA utility bonds and the Bond Buyer Index of 20 Municipals for the period 1990 to 1995, as reported in: Data Resources, Inc., U.S. Long-Term Review, Summer, 1983, Table 11.7, p. 1.136.

The first decommissioning funding method considered is negative salvage value depreciation. Under this method of funding decommissioning costs, the additional depreciation charge for accounting purposes each year over the plant life would be $16.3 million. This is obviously substantially in excess of the equal treatment deduction. Utility revenues would not increase by this amount each year over the life of the plant. Under this funding method the cumulated decommissioning charges are deducted from the utility's rate base as additional depreciation on the plant. This growing deduction from rate base yields an increasing reduction in utility rates over the plant's life. Under current tax treatment, utility rates are also affected by the process of "normalization," a ratemaking procedure which offsets the effects of the difference in timing of the recognition of decommissioning costs under regulatory accounting rules versus income tax accounting rules (explained in more detail in Appendix II). Using the equations in Appendix II, it can be shown that these factors combine to produce linear patterns in the utility's revenues (utility rates), tax payments, and cash flows over the life of the nuclear plant.

These patterns are summarized in table 1, and the effects on utility revenues are shown graphically in figure 1. Under current tax treatment utility revenues are higher by $15.6 million in the first year of the plant's operation due to the decommissioning funding mechanism. The effect decreases by $1.5 million each year, however, and becomes a negative effect on utility rates beginning in the 12th year. By the last year of the plant's operating life, utility rates are actually $34 million less than they would have been without the decommissioning funding mechanism because the deduction from rate base by this time has grown to exceed $300 million. To facilitate comparison of the alternative financial streams, present values were calculated using a

TABLE 1. Summary of Simulation Results for Negative Salvage Value Depreciation (million of dollars)

Item	First Year Effect	Initial Year of Negative Value	Effect in Last Year of Plant Life	Effect in Year of Decommissioning	Present Value
Utility Revenue (Rates)					
Current Tax Treatment	$15.6	12th	-$34.0	-$25.5	$30.4
H.R. 2820	15.0	7th	-76.8	-47.2	-78.4
Tax Payments					
Current Tax Treatment	7.3	16th	-9.3	-271.3	-22.2
H.R. 2820	-0.5	1st	-31.2	-15.8	-79.2
Utility Cash Flow					
Current Tax Treatment	8.5	16th	-11.0	-318.5	26.0
H.R. 2820	15.8	16th	-20.3	-589.8	48.2

Source: The data were derived using the simulation model described in Appendix II and assumptions stated in the text.

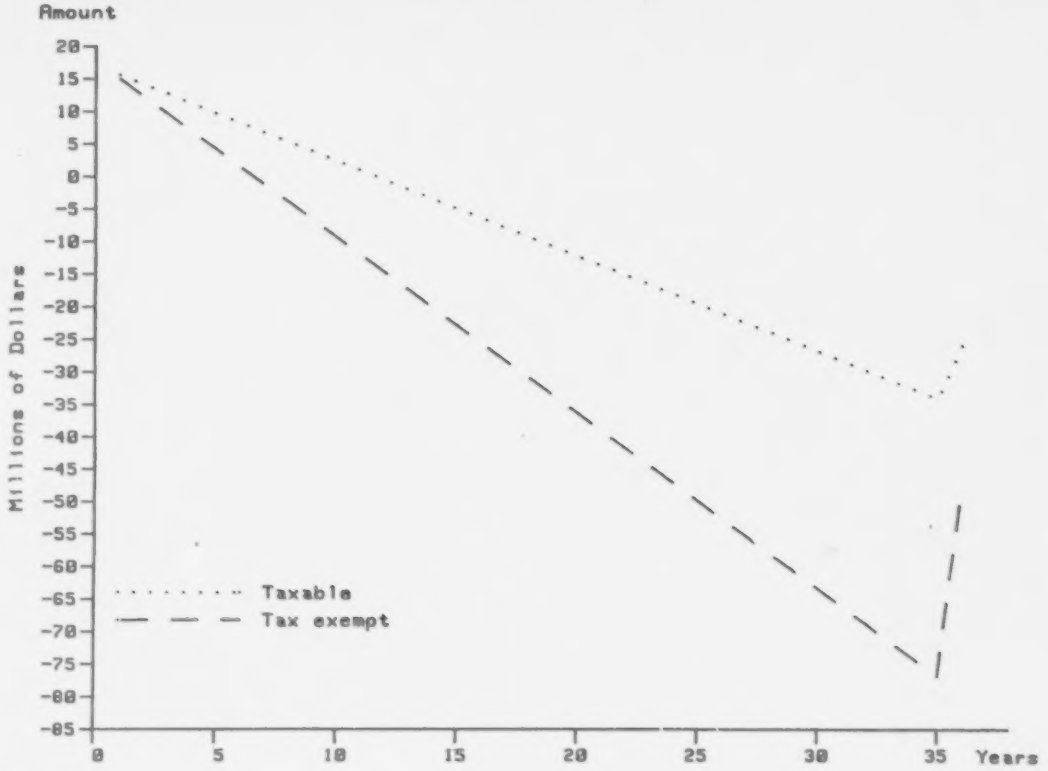

Figure 1

Effect of Decommissioning Charges on Utility Revenues
Negative Salvage Value Depreciation

discount rate of ten percent, the rate assumed on taxable bonds in the simulations. Under current tax treatment the present value of the effect on utility revenues is $30.4 million.

Since the annual decommissioning charge under negative salvage value depreciation is much larger than the equal treatment deduction, it is not surprising to discover that H.R. 2820 would provide substantial benefits for utilities using this decommissioning funding method, and the customers of those utilities.

In the simulation of negative salvage value depreciation under H.R. 2820 the effect on utility revenues turns negative more quickly, and, notably, the present value of the effect on utility revenues is a substantial negative amount. 18/ In this case, the utility customers would actually receive a significant long-term benefit from the requirement to fund decommissioning costs. The reason for this benefit is that the utility's customers earn a return on their payments for decommissioning at the utility's pre-tax rate of return. This return is received through reduced utility rates because the decommissioning charges are excluded from the utility's rate base, and under H.R. 2820 there would be no tax accruals to offset this effect. If one is required to make annual contributions into a fund on which he receives a high rate of return for a long time period, the individual can benefit from this procedure even if his contributions are never returned. This is essentially the situation utility customers are in under negative salvage value depreciation and the tax deductibility offered by H.R. 2820.

18/ The revenue effects in the year of decommissioning in these two cases occurred because the simulation model assumes the ratemaking treatment to be based on the average balances in the utility's accounts during the year, a typical ratemaking practice. The plant is assumed to be decommissioned at a uniform rate in the 36th year.

In contrast to the results under H.R. 2820, if the constant equal treatment deduction of $454 thousand per year were allowed, utility rates would be about $35 thousand lower than under current tax treatment in the first year and about $1.2 million lower in the final year.

The effects on tax payments by the utility are reported in the middle portion of table 1 and are also shown graphically in figure 2. The patterns of the tax payments reflect both the direct effects of the different tax treatments and the indirect effects of the different utility revenue patterns. Under the current tax treatment the tax payment begins at $7.3 million and then declines as utility revenues also decline. The effect on tax payments in this case is negative after the 15th year; while the Treasury receives tax payments on the annual decommissioning charge, this is more than offset by the reduction in taxes attributable to lower utility revenues resulting from deducting the cumulated decommissioning charges from the rate base. In the year of decommissioning the tax revenue loss in this case is $271.3 million, which largely reflects the deduction of decommissioning costs. The present value of the tax payments is $22.2 million.

Under H.R. 2820, under which the decommissioning charges would be tax deductible, a tax revenue loss occurs every year because of the growing deduction from the utility's rate base. The present value of tax effects in this case is -$79.2 million. If the level equal treatment deduction were allowed, tax collections would be only slightly lower than under current tax rules; the amount would grow to about $1.1 million in the 35th year.

The alternative tax treatments also affect the cash flow of the utility because under negative salvage value depreciation the decommissioning funds are held by the company and invested in its assets prior to being required

to pay for decommissioning. The cash flow effects are reported in the lower portion of table 1. The cash flows in the year of decommissioning reflect the cost of paying for decommissioning, partially offset by the tax deduction under current tax treatment. In both cases the utility company derives a substantial long-run cash flow benefit from the decommissioning funding procedure, as indicated by the present values. These cash flow benefits produce the lower utility rates (shown at the top of the table) as the cost-free decommissioning reserve is substituted for external financing.

This simulation of the effects of negative salvage value depreciation assumes that the procedure is carried out in a manner fully consistent with the logic of the accounting system. There are many variations of the procedure used in actual practice, however. Specifically, the depreciation charges of many utilities, as approved by their regulatory agencies, apparently do not allow fully for inflation in the cost of decommissioning. Rather, the negative salvage value depreciation may be based on estimated decommissioning costs at the time of a rate hearing, and then the costs may be updated at future rate hearings to incorporate the inflation which has occured. This approach leads to a pattern of increasing depreciation charges rather than a level charge over the life of the plant. The procedure also does not fully provide for the eventual cost of decommissioning. Because of this and the somewhat ad hoc pattern of depreciation charges, this approach is difficult to simulate. A simulation was run, however, in which the negative salvage value depreciation charge in the first year was based on the estimated decommissioning costs in that year, and the charge was increased each year at the assumed rate of inflation in decommissioning costs. This approach also requires a large decommissioning charge in the last year to make up for the

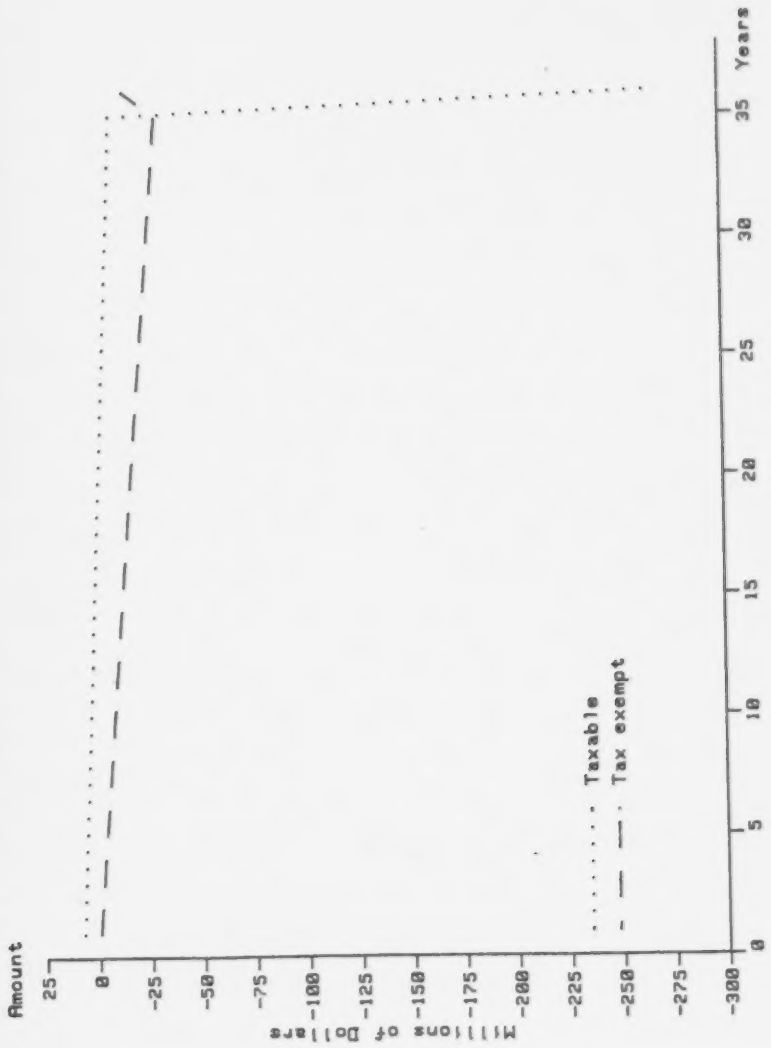

Figure 2

Effect of Decommissioning Charges on Tax Payments
Negative Salvage Value Depreciation

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unfunded costs. In this simulation the effects over the life of the nuclear plant were smaller, but the aggregate tax deductions over the life of the plants still substantially exceeded the equal treatment deduction.

Simulation results for the sinking fund methods of financing nuclear power plant decommissioning costs are summarized in table 2. The external sinking funds yield constant utility rate effects over the life of the plant. The simulations assume that the decommissioning charges to customers are grossed up to cover taxes and that interest on the fund is on a net of tax basis; hence there is no tax normalization procedure. Since the funds are external there also are no cash flow effects. The cost of this funding procedure is higher if the sinking fund is invested in taxable securities because of the lower after-tax rate of return. For this reason, in practice, all known external decommissioning funds are invested in tax-exempt securities. The internal sinking fund generates utility rate effects which start smaller than the external funds but grow to much larger amounts. The annual decommissioning charge under this funding method ($850 thousand) is smaller because the utility's internal rate of return is higher than the rates which can be earned on the external funds. The utility rate increase grows over the life of the plant, however, because the internal fund replaces external financing, which reduces the utility's interest deductions and increases its tax payment. The increasing tax payment is what forces the utility rates up. Even with the increasing rates, however, the internal sinking fund method yields utility rates which are somewhat lower than the external fund in present value terms. Not surprisingly, under each of the funding methods the utility rate increases required to fund decommissioning are higher under current tax treatment than under H.R. 2820.

TABLE 2. Summary of Simulation Results for Sinking Funds (millions of dollars)

Item	First Year Effect	Effect in Last Year of Plant Life	Effect in Year of Decommissioning	Present Value
UTILITY REVENUES (RATES)				
External Fund Invested in Tax-Exempt Securities				
Current Tax Treatment	$3.1	$3.1	0.0	$29.7
H.R. 2820	1.8	1.8	0.0	17.6
External Fund Invested in Taxable Securities				
Current Tax Treatment	5.5	5.5	0.0	53.5
H.R. 2820	3.5	3.5	0.0	34.2
Internal Sinking Fund				
Current Tax Treatment	1.5	12.0	$5.5	23.2
H.R. 2820	0.9	11.8	5.8	17.2
TAX PAYMENTS				
External Fund invested in Tax-Exempt Securities				
Current Tax Treatment	1.4	1.4	-262.8	5.9
H.R. 2820	0.0	0.0	-233.5	-6.9
External Fund Invested in Taxable Securities				
Current Tax Treatment	2.6	15.5	-254.3	35.7
H.R. 2820	0.1	15.3	-195.9	16.3
Internal Sinking Fund				
Current Tax Treatment	0.7	11.2	-257.2	7.5
H.R. 2820	0.0	11.0	-243.3	1.6

TABLE 2. Summary of Simulation Results for Sinking Funds (millions of dollars) continued

Item	First Year Effect	Effect in Last Year of Plant Life	Effect in Year of Decommissioning	Present Value
UTILITY CASH FLOW				
External Fund Invested in Tax-Exempt Securities				
Current Tax Treatment	0.0	0.0	0.0	0.0
H.R. 2820	0.0	0.0	0.0	0.0
External Fund Invested Taxable Securities				
Current Tax Treatment	0.0	0.0	0.0	0.0
H.R. 2820	0.0	0.0	0.0	0.0
Internal Sinking Fund				
Current Tax Treatment	0.8	13.2	-301.9	8.8
H.R. 2820	0.9	13.7	-315.3	9.2

Source: The data were derived using the simulation model described in Appendix II and assumptions stated in the text.

The annual decommissioning charges under all of the sinking fund methods are higher than the equal treatment deduction. The annual charge under the internal sinking fund method, which has the lowest charge, is nearly twice as large as the equal treatment deduction. If the equal treatment deduction were allowed, utility rates under these funding methods would decrease approximately $387 thousand from the levels under current tax rules.

Under current tax rules, tax payments on the external fund invested in tax-exempt securities are constant over the life of the plant, and a large reduction in tax payments occurs in the year of decommissioning due to deduction of its cost. The tax collected during the life of the plant is the tax on the charge collected from the utility's customers to fund the external reserve. Under H.R. 2820 the external fund in tax-exempt securities would yield no tax receipts during the life of the plant; in the year of decommissioning the tax deduction would be claimed for the decommissioning cost less the deductions claimed during the plant life. Tax receipts increase each year from an external fund invested in taxable securities because of the increasing amount of taxable interest earned by the fund. Tax receipts also increase each year under the internal sinking fund method because of the declining interest deduction of the utility, as explained above. If the equal treatment deduction were allowed, tax payments under each of the sinking fund methods would decrease by about $209 thousand per year from the levels under current tax rules.

Only the internal sinking fund method affects the cash flow of the utility. During the plant life the cash flow increases due to the reduced interest payments on debt; during the year of decommissioning there is a large cash outflow because decommissioning is financed from internal funds. In present value terms, the net effect of these cash flows on the utility is positive.

As stated at the beginning of this section, the specific results displayed in table 1 and 2 are, of course, dependent on the assumptions made in the simulation. Altering the assumptions changes some of the relationships between results in the alternative cases, but does not change the fundamental pattern. Shortening the assumed life of the nuclear power plant increases some of the annual data while reducing others; there is a shorter time within which to accumulate the fund to pay for decommissioning, but inflation also would have a smaller effect on the cost of decommissioning. In terms of present values, a shorter plant life has a larger effect on tax revenues and cash flows than on utility rates, but the basic relationships in the simulation presented in the table remain. Lowering the assumed inflation rate (leaving interest rates unchanged) reduces the magnitude of all the results, but leaves all of the basic relationships unchanged. Increasing the interest rates assumed to be earned on the external sinking funds reduces the effects on utility revenues and tax payments of the external sinking fund cases. The present values are, of course, sensitive to the assumed discount rate. A lower discount rate reduces the present values associated with negative salvage value depreciation and increases the present values associated with the sinking fund methods. 19/

19/ Simulation values under alternative assumptions will be made available by the author upon request.

V. POLICY IMPLICATIONS

The analysis in this paper has shown that the current tax treatment of nuclear power plant decommissioning costs, considered in isolation, raises the effective tax rate on investments in these plants. Treatment fully consistent with the tax treatment of other investments which do not have negative salvage values would allow a partial deduction for decommissioning costs over the life of a nuclear plant. This deduction has been referred to in this paper as the "equal treatment deduction".

Some observers would argue, however, that the tax treatment of decommissioning costs should not be considered in isolation from other aspects of the tax treatment of nuclear power plants. The 10-year ACRS life applicable to nuclear power plants, as contrasted to the 15-year ACRS life applicable to other similarly long-lived public utility property, provides a reduction in effective tax rates which is substantially greater than the penalty associated with current tax treatment of decommissioning costs. From this perspective, therefore, nuclear power plants would be regarded as already being treated more favorably than other comparable investments under the tax code, so no correction of the treatment of decommissioning costs would be justified.

If this view does not prevail and the current tax treatment of nuclear power plants is regarded as appropriate in all regards except for the treatment of decommissioning costs, then the current treatment of these costs can be shown to impose a tax penalty. This penalty is extremely small: less than one-half percent in terms of the effective tax rate. One policy question is

whether this difference is large enough to merit policy revision in light of other much larger differences in effective tax rates under our tax code. Nonetheless, it is a penalty and it has real effects; utility customers must pay more to cover the cost of decommissioning nuclear power plants than if the tax penalty did not exist.

The most direct approach to eliminating this penalty, and the one most consistent with the structure of the tax code, would be to allow specified deductions for decommissioning costs over the life of the nuclear plant, much like depreciation deductions. To be consistent with the actual economic effects of the future decommissioning costs, the deductions should be small early in the plant's life and grow larger late in its life, the opposite pattern from accelerated depreciation. It would be possible to use other patterns of deductions, however, and achieve the same economic result over the life of the plant. 20/ If, for example, it were desired to allow a level deduction over the life of the plant, the calculations in appendix I indicate that an annual deduction of approximately 0.045 percent of the original cost of the plant, with the remainder of the cost deductible in the year of decommissioning, would eliminate the penalty, given the assumptions used in this study.

The primary disadvantage of this approach is that it would be difficult to know the actual appropriate amount to allow as a deduction for decommissioning costs. The amount of the deduction cited above is based on the assumptions used in this study, which are believed to be consistent with the best information currently available. But the appropriate amount for the deduction depends on

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20/ A deduction pattern which deviates from the pattern of economic effects would necessitate a recapture provision.

the expected future cost of decommissioning, the time period over which the decomissioning will occur, the inflation rate in costs of decommissioning, and rates of interest from the present to the decommissioning period.

The expected cost and time period for decommissioning vary significantly from one nuclear plant to another depending on its size, location, the decommissioning method to be used, environmental factors, and public safety concerns. Thus, the size of the appropriate decommissioning deduction could vary significantly from one utility to another. Futhermore, each of the factors affecting decommissioning costs is highly uncertain, which implies that estimates of the appropriate deduction will change in the future as expectations and cost estimates change.

A second policy approach to offsetting the penalty resulting from present tax treatment of decommissioning costs would be to allow deductions based on the actual additions to reserves for funding decommissioning. This is the approach which would be implemented by H.R. 2820. It may seem initially that these payments should be deductible by the company under the present structure of the tax code, since these are the company's actual outlays to pay for decommissioning. But the reserve mechanism is a financing scheme much like a mortgage or a bond sale which is used to finance the purchase of a factory. The depreciation deductions on a factory (or utility plant) do not depend on the pattern of repayment of the principal of the mortgage or of retirement of the bonds. Rather, the pattern of depreciation deductions is established so as to have the desired economic effect in determining the effective tax rate on the investment. Similarly, the economically appropriate pattern of tax deductions for the future decommissioning cost does not depend on the particular financing method used to provide for the cost.

Nonetheless, if allowing deductions for additions to the decommissioning reserve would achieve roughly the desired economic result (i.e. effective tax rate), then there could be an advantage to this approach. The amount of the allowable deduction would not have to be specified by the tax authorities, thus avoiding the necessity of the Congress and the Treasury dealing directly with the uncertainty surrounding decommissioning costs. The deduction would be determined by the calculations made by the utilities and their regulators in establishing the decommissioning funding procedure. The same factors which determine the economically appropriate amount for the equal treatment deduction also determine the amounts which must be set aside in a reserve to fund the future decommissioning cost. These factors are no less uncertain, of course, to the utilities or their regulators, but, since they are responsible for funding decommissioning, they must make their best efforts to deal with them. Since additions to the reserves are subject to scrutiny in utility ratemaking procedures, and larger reserve additions mean higher utility rates for customers, the regulatory process provides a check on the reasonableness of the decommissioning charges. Furthermore, as estimates of factors affecting decommissioning cost change, the reserve additions are revised; thus, under this approach, the tax deduction would be self-correcting.

Yet the simulations in section IV reveal that the additions to decommissioning reserves under all funding methods substantially exceed the size of the equal treatment tax deduction. This implies that allowing a full deduction for these reserve additions would entail providing a tax subsidy for decommissioning costs, in the sense that the nuclear power plant investment would be treated more favorably than other investments without negative salvage values. To gain the advantages of relying on the decommissioning funding

mechanism to determine the amount of the allowable tax deduction, it may be possible to allow a deduction for a fraction of the reserve addition. The results in table 2 suggest that allowing deduction of between one-fourth and one-half of annual reserve additions would, on average, approximate the equal treatment deduction for the sinking fund financing methods.

The negative salvage value depreciation method of funding decommissioning costs yields annual decommissioning charges which substantially exceed the decommissioning charges under the sinking fund methods. Thus, to avoid providing inappropriately large benefits to some utilities, the availability of the deduction may have to be restricted to only those reserves which operate on a sinking fund basis. Alternatively, deductions for utilities which use negative salvage value depreciation could be limited to amounts which would be deducted under a sinking fund approach; however, this would increase the administrative difficulties and partly eliminate the advantage of relying on reserve contributions to determine the decommissioning deduction. Even for those utilities which use a sinking fund approach, the Treasury would, as part of routine enforcement procedures, have to pass judgment on the reasonableness of the decommissioning deduction, presumably including all of the assumptions regarding the uncertain factors which determine the deduction.

A further issue involving this approach is the recapture of excess reserves. Since under H.R. 2820 or some modification of this approach the utilities would, in effect, determine the size of their own tax deductions (with regulatory oversight), provisions would have to be put into place to

guard against attempting to profit from the system by making excess reserve contributions to gain the advantage of tax deferral. So long as any amounts in the decommissioning reserve, including accrued interest, which exceed the actual cost of decommissioning are treated as taxable income when returned to the utility, this should be a sufficient safeguard in most cases. 21/ The only exceptions would be instances in which the utility earned a higher rate of return on its decommissioning reserve than its discount rate (rate of return), which would be expected to be rare. Again, however, the negative salvage value depreciation method of decommissioning funding would create problems because, under this procedure, the utility customers earn a return on their payments for decommissioning at the utility's pretax rate of return (since the depreciation charges are deducted from the rate base). In this case, if the decommissioning charges were tax deductible, the customers would derive significant benefit in terms of lower utility rates from excess decommissioning payments, even with a recapture provision.

Even in the absence of attempting to "profit from the system" it may be expected that if full or partial tax deductibility were provided for additions to decommissioning reserves, the amounts set aside in these reserves would be likely to increase in the future. Tax deductibility would reduce the cost to utility customers of providing the reserve funding. To the extent that the reserves are currently being underfunded, or that utilities and their regulatory agencies may wish to increase the degree of assurance of fund sufficiency,

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21/ The provision would be more complicated if reserve contributions were partially deductible. In this case a fraction of excess reserves would be taxable. The fraction is equal to $D/(1-T+DT)$, where D is the proportion of reserve contributions which are deductible and T is the marginal tax rate.

reducing the cost of providing the reserves would be expected to lead to decisions to increase the size of the reserves.

A final issue was mentioned in section II: the problem of the single-asset utility company which operates a nuclear power plant and will not continue to have income beyond the life of the power plant. For this company, current tax rules, in effect, deny a deduction for some or most of the cost of decommissioning. The policy changes discussed above would relieve this problem by providing some deductions over the life of the plant while taxable income is being earned. However, the policy changes whould not put the single-asset utility in a situation comparable to other utilities because the single-asset company still would be unable to utilize the deduction at the time of decommissioning for costs which had not previously been deducted. The most direct policy approach to solving this problem would be to allow an extended carryback of net operating losses experienced by electric utilities resulting from the costs of decommissioning nuclear plants. Under this policy, during the decommissioning period the utility could receive the refund of taxes paid in prior years as a means of receiving the benefit of deducting decommissioning costs if it had insufficient current tax liability to absorb the deduction. There are several precedents for allowing extended net operating loss carryback periods for industries or situations in which there is limited ability to absorb current deductions. For example, losses arising from product liability may be carried back 10-years. A potential problem with the extended loss carryback approach to decommissioning costs, however, is that the carryback period allowed may have to be very long, especially if a decommissioning method other than DECOM is used. It is uncertain whether carryback periods of 40 to 100 years or more are administratively feasible.

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APPENDIX I

CAPITAL COST RECOVERY OF NEGATIVE SALVAGE VALUE: GENERAL CONCEPTS AND APPLICATION TO NUCLEAR POWER PLANT DECOMMISSIONING COSTS

The economic theory of capital cost recovery (tax depreciation) has been rather extensively developed. 22/ However, this development has not included attention to the tax treatment of investment costs which occur at the end of a project's life, or negative salvage value (as opposed to the more typical case of an investment which has a positive salvage value at the end of its life). This appendix explores the tax treatment of negative salvage value within the framework of existing theory.

It is useful initially to consider the problem within the context of two polar types of tax depreciation: expensing and economic depreciation. It is also helpful to abstract from the effects of inflation and consider all amounts in real (inflation adjusted) terms. Assume that an example investment project will yield positive cash flow F_i during each year of its useful life, i=1,2, ... n-1, and in year n will cost S to terminate (S may represent nuclear power plant decommissioning, mining reclamation, drilling rig removal, etc.). In the absence of a tax system, if the real rate of return generally available on

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22/ For recent overviews of the theory see: Harberger, Arnold C., Tax Neutrality in Investment Incentives, in, Aaron, Henry J. and Michael J. Boskin, Eds., The Economics of Taxation, The Brookings Institution, Washington, D.C., 1980. p. 299-313; and Gravelle, Jane G., The Capital Cost Recovery System and the Corporate Income Tax, Report No. 79-230 E, Congressional Research Service, Library of Congress, November 26, 1979, 165 p. (see esp. p. 28-41).

investment projects is r, then the value of the example investment, PV_o (for present value at time 0), will be as follows:

$$1) \quad PV_o = \sum_{i=1}^{n-1} \frac{F_i}{(1+r)^i} - \frac{S}{(1+r)^n}$$

Equation 1 is a full representation of the economic characteristics of the investment, showing the relationships between its initial and final costs, the income the investment generates, its useful life, and its rate of return.

Now assume that a tax system is imposed which allows full expensing of all costs associated with an investment project (that is, costs are immediately deductible). 23/ If the tax is imposed at a rate t, this means that all cash flows associated with the investment, both the income and costs, are reduced by this rate so the investment project may now be represented as follows:

$$2) \quad (1-t)PV_o = \sum_{i=1}^{n-1} \frac{(1-t)F_i}{(1+r^*)^i} - \frac{(1-t)S}{(1+r^*)^n}$$

where r^* is now the aftertax real rate of return. However, since equation 2 reduces to equation 1 (the term (1-t) cancels out of equation 2), $r^*=r$. That is, in this case the tax system does not change the rate of return on the investment. Thus, a tax system which allows expensing imposes an effective tax rate of zero, where the effective tax rate is defined as $(r-r^*)/r$. This conclusion is valid regardless of whether equations 1 and 2 include the last terms involving the negative salvage value. This fact demonstrates that immediate deduction of the salvage expense is consistent with a system of expensing in that it preserves the effective tax rate (specifically, zero).

23/ For simplicity, the discussion in this appendix assumes the investor can fully realize all tax deductions.

At the opposite end of the spectrum from expensing is economic depreciation. Under a system of economic depreciation the effective tax rate is equal to the statutory tax rate. Economic depreciation allows the decline in the real value of the asset each year to be deducted as the depreciation expense. 24/ The value of an investment asset at the beginning of year t of its useful life may be expressed as follows:

$$3) \qquad PV_t = \sum_{i=t}^{n-1} \frac{F_i}{(1+r)^{(i-t+1)}} - \frac{S}{(1+r)^{(n-t+1)}}$$

Since economic depreciation for year t, ED_t, equals the decline in value of the investment in year t, it is equal to:

$$4) \qquad ED_t = PV_t - PV_{(t+1)}$$

Substituting equation 3 into equation 4 and simplifying leads to:

$$5) \qquad ED_t = \frac{F_t}{(1+r)} - r\sum_{i=t+1}^{n-1} \frac{F_i}{(1+r)^{(i-t+1)}} + \frac{rS}{(1+r)^{(n-t+1)}}$$

This formula may be interpreted quite usefully. The first term to the right of the equal sign is the contribution to economic depreciation in year t of the cash flow in year t. That is, at the end of year t the asset is less valuable because the cash flow during year t has now been received. The second term in equation 5 represents the contribution to the change in the asset's value in year t of all the positive cash flows (receipts) after year t. These cash flows affect the value of the asset during year t because at the end of the year, they

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24/ The economic effects of economic depreciation will not be proved here. Proofs are available in the literature; see, for example, Samuelson, Paul A., Tax Deductibility of Economic Depreciation to Insure Invariant Valuations, Journal of Political Economy, December 1964. p. 604-606.

are one year closer to being received than at the beginning of the year. The second term in the equation is negative. The decline in value (economic depreciation) of the asset in year t will reflect the receipt of F_t, but this decline will be offset to some extent by the higher value of the future cash flows because they are now one year closer. 25/ The last term in equation 5 shows the contribution to economic depreciation in year t of the salvage cost of the asset. It has an effect on economic depreciation opposite to that of the future positive cash flows; that is, it enlarges the decline in the asset's value because the required salvage payment is one year closer at the end of year t than at the beginning.

Equation 5 clearly indicates that every future cash flow associated with the investment affects the amount of economic depreciation in year t. Specifically, under economic depreciation, an expense occurring in the last year of the asset's life (or spread over several years at the end of the asset's life) will generate tax deductions in each year of the asset's life.

At first, this result may seem anomalous. Negative salvage value receives more favorable tax treatment (that is, it is allowed to be deducted earlier) under economic depreciation, which results in a positive effective tax rate, than under a system of expensing, which results in a zero effective tax rate. The results, however, are really quite consistent. Under a system of expensing, each cash flow of the investment project generates two effects on taxable income: one in the year the asset is purchased and the second in the year the cash flow actually occurs. The two effects are opposite in sign and, in terms of present value, are equal in magnitude. Thus, every cash flow has a net effect of zero on

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25/ If cash flow in year t is zero, but there are positive cash flows in future years, economic depreciation in year t will be negative. That is, the value of the asset will increase during the year and that increase would be taxable.

taxable income, in present value terms. A positive cash flow in year t will be taxable when received, but its present value is deducted when the asset is purchased (the purchase price of the asset, which equals the sum of the present values of the future cash flows, is immediately deducted). Obversely, a negative cash flow in year t will be fully deductible when expended, but its present value has an effect equivalent to receipt of taxable income when the asset is purchased (the purchase price of the asset will be lower than otherwise by an amount equal to the present value of the future expense, thus reducing the amount to be expensed at the time of purchase). Hence, under a system of expensing, income and expenses are moved from one year to another, but, in present value terms, there is no net effect; receipt of income generates no net taxable income and expenses associated with the investment generate no net deductions. This is why the system results in an effective tax rate of zero; in present value terms, taxable income and deductions over the asset's life net to zero.

A system of economic depreciation, on the other hand, effectively imposes a tax. Under economic depreciation, each cash flow in the investment project generates effects on taxable income every year from the date of purchase through the year of the cash flow (see equation 5). The present value of these effects on taxable income is non-zero and has the same sign as the cash flow. Thus, in present value terms, under economic depreciation receipts generate net taxable income, expenses generate net deductions, and taxable income associated with the investment has a positive present value (assuming the investment has a positive pretax rate of return). Since expenses do generate net tax deductions in present value terms, taken in isolation the treatment of expenses is more beneficial under economic depreciation than under expensing. However, the effects of the treatment of expenses are more than offset by the effects of the treatment of receipts, resulting in a positive effective tax rate under economic depreciation.

While expensing and economic depreciation are useful analytical benchmarks, neither system is incorporated into the U.S. tax code. Present tax rules allow an investment credit and a series of capital cost recovery deductions which, for most investments, yield an effective tax rate falling somewhere between zero and the statutory tax rate. 26/ In the absence of any clear conceptual model to which the tax system conforms, the tax treatment of a particular characteristic of an investment may be evaluated on the grounds of neutrality; that is, how does the effective tax rate on the investment compare to that on a "similar" investment without the subject characteristic? This will indicate whether investments with the characteristic are being treated more or less favorably than similar investments without the characteristic.

Applying this standard requires identifying a similar investment to use as the benchmark. As an initial example, an investment with identical characteristics to the negative salvage value investment except for the cash outflow in the last year (and the resulting required change in the positive cash flow during the life of the investment to maintain the same aftertax rate of return) will be used as the benchmark. This benchmark investment may be represented as follows:

$$6) \qquad PV_b = \sum_{i=1}^{n} \frac{(1-t)F_i}{(1+r^*)^i} + \sum_{i=1}^{m} \frac{tD_i}{(1+r^*)^i} + I$$

where D_i is the real value of the depreciation deduction allowed in period i, m is the tax depreciation period for the investment, and I is the investment tax credit. This formula may be used to calculate the effective tax rate on the investment by first calculating the F_i (assumed to be constant over the life of

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26/ See Gravelle, Jane G. Capital Income Taxation and Efficiency in the Allocation of Investment. National Tax Journal, September 1983. p. 297-306, esp. tables 1 and 2.

the investment) required to provide a given aftertax rate of return, and then calculating the resulting pretax rate of return on the investment.

The same assumptions used in the examples in the text (section IV) are used in the calculations here. The aftertax nominal rate of return is assumed to be 11 percent, the inflation rate is assumed to be 6 percent, and the marginal tax rate is assumed to be 46 percent. The investment is assumed to have a useful life of 35 years, to qualify fully for the investment tax credit, and to qualify for 10-year ACRS deductions (with the 5 percent basis adjustment). Under these assumptions, the investment would have an effective tax rate of 20.51 percent. 27/

This benchmark may be compared to another investment which is identical except for a negative salvage value requiring a cash outflow in the 36th year. Under present tax rules, this investment would be represented as follows:

$$7) \quad PV_s = \sum_{i=1}^{n} \frac{(1-t)F_i}{(1+r^*)^i} + \sum_{i=1}^{m} \frac{tD_i}{(1+r^*)^i} + I - \frac{(1-t)S}{(1+r^*)^{n+1}}$$

where the negative salvage value, S, is assumed to equal 7 percent of the original cost of the investment in real terms. 28/ Under the same assumptions, this investment would have an effective tax rate of 20.84 percent. This result is consistent with the conclusions drawn above from the comparison between expensing and economic depreciation. Expensing treatment of negative salvage value is not consistent with a tax system which achieves a positive effective tax rate. The negative salvage value investment is treated less favorably than this benchmark investment by the current tax rules, however the differential in effective

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27/ All calculations were carried out on a quarterly basis.

28/ This represents a cost which would be 5 percent of the original cost at the time of the investment, but which is subject to a 7 percent inflation rate (compared to the general rate of 6 percent), thus increasing the real salvage cost during the 35 years of the investment's life.

tax rates is extremely small given the assumed characteristics of this investment. 29/

Equalizing the effective tax rates on these two investments would require allowing deductions with regard to the negative salvage value which are more generous than the expensing treatment under current tax rules. One way to achieve this would be through the appropriate linear combination of expensing and economic depreciation of the decommissioning cost, however, other patterns for the required deductions can be calculated. If, for example, a constant nominal deduction were to be taken each year over the life of the asset, with the portion of the negative salvage value which has not yet been deducted to be claimed at the time of the expense, the amount of the annual deduction can be determined with some modifications to equation 7. For a nuclear plant which cost $1 billion to construct, for example, the annual deduction for the eventual decommissioning cost would be approximately $ 0.454 million per year (using the same assumptions as in the other calculations). This deduction seems small compared to the cost of the plant and the decommissioning cost, but it is large enough to raise the present value of the tax deduction associated with the decommissioning cost by 28 percent.

Some observers would argue, however, that the tax treatment of decommissioning costs should not be considered in isolation from other aspects of the tax treatment of nuclear power plants. Specifically, under the ACRS depreciation

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29/ The result is not very sensitive to the assumed characteristics. The difference in effective tax rates between the benchmark investment and negative salvage value investment remains substantially below 1 percentage point if the assumed useful life is decreased to 20 years or if the negative salvage value is doubled.

rules, nuclear power plants are depreciated over a 10-year period, whereas other public utility property which is equally long-lived must be depreciated over a 15-year period. Those who regard the shorter depreciation period for nuclear plants as a special benefit would argue that the appropriate benchmark for evaluating the nuclear power plant investment is an identical investment except with a 15-year ACRS period and no decommissioning cost. Using the same assumptions as in the earlier calculations, such a benchmark investment would have an effective tax rate of 27.94 percent, compared to the effective rate of 20.84 percent on the nuclear power plant investment. This comparison suggests that the advantage of 10-year depreciation for nuclear power plants is far greater than the disadvantage associated with current tax treatment of decommissioning costs.

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APPENDIX II

A MODEL OF THE EFFECTS OF ALTERNATIVE TAX TREATMENTS OF THE COSTS OF DECOMMISSIONING NUCLEAR POWER PLANTS

This appendix presents a summary of the computer model developed to simulate the effects of alternative tax treatments of the costs of decommissioning nuclear power plants. The funding mechanisms and ratemaking procedures characterized in the model are representative of practices in the utility industry. Since there is wide variation in specific aspects of these procedures, however, the practices of any specific company may differ from those represented here.

The revenues of investor-owned electric utilities are regulated on a rate of return basis: that is, the companies are allowed to charge utility rates which are intended to generate revenues sufficient to cover operating costs and to provide a "fair and reasonable" rate of return on invested capital. In simple terms the utility ratemaking formula may be thought of as follows: 30/

$$8) \qquad R_1 = r[V - \sum D + w] + D + C + T_1$$

where R_1 is the amount of revenues to be collected by the utility through charges to customers, r is the rate of return which the utility is allowed to earn, 31/ V is the gross value of assets in the utility's rate base, D is the amount of depreciation on the utility's plant and equipment in the current year, $\sum D$ is the

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30/ To focus the analysis on decommissioning costs, complexities such as the treatment of construction work in progress and normalization of accelerated depreciation and the investment tax credit are ignored.

31/ The actual rate of return earned by the utility depends on economic circumstances and will usually differ from the allowed rate of return used to calculate authorized utility rates.

cumulated depreciation on the assets in the utility's rate base, w is the amount of working capital, C is operating costs, and T_1 is taxes. The term in brackets is the rate base in this simple model. The precise definition of the rate base varies from one regulatory agency to another; essentially, however, it consists of an estimate of net utility plant plus working capital. For economic and financial analysis it is useful to think in terms of the financial analogue of the rate base. Since the rate base is an estimate of the value of the utility's assets, it must be equivalent to the amount of investment capital used to finance those assets.

In this simple model, which assumes a simple income tax structure, the tax on the utility's net income would be calculated as follows:

$$T_1=t(R_1-D-C-u_1) \qquad 9)$$

where t is the tax rate, and u_1 is the amount of interest paid, which is calculated as follows:

$$u_1=ai[V-\sum D+w] \qquad 10)$$

where i is the embedded interest rate on the utility firm's debt, and a is the debt ratio (debt as a proportion of total capitalization).

Equations 8, 9, and 10 constitute the "base case" used in the simulation analysis; this case represents a utility which does not have a nuclear power plant and therefore has no costs associated with decommissioning.

For utilities with nuclear power plants, the most common approach to decommissioning funding is negative salvage value depreciation. Under this procedure the utility increases its annual charge for depreciation by an amount intended to "recover" the expected cost of decommissioning. While this seems conceptually simple, the full implications of the procedure are complex due to the process of "normalizing" the tax consequences which result from recognizing an expense

for ratemaking purposes which is not recognized for tax purposes. Under negative salvage value depreciation the equations for utility revenues, taxes, and interest payments would appear as follows:

$$11) \quad R_2 = r[V - \sum D + w - (1-t)\sum(d_s - d_a)] + D + d_s + C + T_2 - t(d_s - d_a)$$

$$12) \quad T_2 = t(R_2 - D - d_a - C - u_2)$$

$$13) \quad u_2 = ai[V - \sum D + w - (1-t)\sum(d_s - d_a)]$$

where d_s is equal to the charge for decommissioning costs (calculated on a straight line basis) and d_a is the actual cost of decommissioning (which equals zero except during the years when decommissioning actually occurs). For modeling purposes, d_s is assumed to be based on the expected future cost of decommissioning, taking the effects of inflation fully into account, even though it is not clear that the full effects of inflation are allowed for in all cases in actual decommissioning charges being authorized by regulatory commissions and used by utilities. The model also assumes that all forecasts and expectations are, in fact, correct so that the actual inflation rate and cost of decommissioning are as predicted even though, in reality, much uncertainty is associated with these variables.

Under negative salvage value depreciation with tax normalization the decommissioning charge is added as a cost of service, and the cumulated decommissioning charges (which are treated as a higher level of depreciation) are deducted from the rate base. Additionally, the procedure entails a normalization treatment which is the reverse of the procedure involved in normalizing the effects of accelerated depreciation. 32/ From the perspective of the ratemaking process,

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32/ For a description and discussion of normalization treatment for accelerated depreciation see: Kiefer, Donald W., The Impact of the Economic Recovery Tax Act of 1981 on the Public Utility Industry, Report No. 82-68, Congressional Research Service, Library of Congress, January 15, 1982, p. 23-35.

the disallowance of the decommissioning charge as a current tax deduction represents a prepayment of taxes which will be recognized for ratemaking purposes in a future year. To put the utility's tax payments recognized for ratemaking purposes on a basis consistent with the ratemaking definition of income, the tax prepayment associated with the denial of the decommission charge as a tax deduction must be subtracted from the actual tax payment, which explains the last term in equation 11. On the other hand, despite the ratemaking treatment, the utility company must, of course, actually pay the higher tax to the Treasury. This tax payment, which is not recovered currently in charges to customers, represents a use of the utility's financial capital (from the ratemaking perspective, it is an interest-free loan from the company to the Treasury). Thus, it is appropriate to allow the utility to earn its rate of return on these cumulated tax prepayments, which is accomplished by adding the cumulated tax prepayments to the rate base (as shown in equation 11). These normalization procedures are accomplished in the utility's accounting statements by subtracting the tax prepayments from deferred income taxes (they represent a negative deferral). When the actual decommissioning costs, d_a, are experienced, they enter the ratemaking formula in the opposite manner from d_e, as shown in equation 11.

The only change in the tax equation in this case is a deduction for the actual costs of decommissioning. The amount of interest payments changes in this case because the utility's requirements for external financial capital change. The amount of the decommissioning charge received from customers each year by the utility is not used to pay a current cost; it, therefore, represents a higher internal generation of funds, and is, in effect, invested in the utility's assets, thereby reducing the firm's need for external capital. On the other hand, the payment of taxes on the decommissioning charge, which

is not recognized in the ratemaking treatment, increases the required capital. Because the taxes are smaller than the decommissioning charge, the net effect of these two influences is to reduce external capital needs. This is accomplished by the last term in equation 13. The model assumes that the higher amount of internally generated funds replaces debt and equity capital proportionately.

If the tax law were amended to permit the current deduction of amounts charged to customers for decommissioning costs, equation 12 would be modified by replacing d_a by d_s and equations 11 and 13 would be changed by eliminating the terms $t\sum(d_s-d_a)$ and $t(d_s-d_a)$. If the utility were a single-asset company which anticipated having no tax liability against which to deduct actual decommissioning costs, the same modifications would be made to equations 11 and 13, but equation 12 would remain unchanged.

The second funding procedure which is used to provide for decommissioning costs is through an external sinking fund. Under this procedure, the utility makes deposits into an external fund which is managed by a fiduciary. The amount of the deposits is calculated so that the deposits plus accrued interest earned on the fund will accumulate to the projected amount required to fund decommissioning. The model assumes that deposits are made in the fund and interest compounds on the fund on a quarterly basis. The amount in the fund at any time can be calculated using the standard annuity deposit formula:

$$14) \qquad E_1 = \frac{d_e[(1+r_e)^n-1]}{r_e}$$

where E_1 is the value of the external sinking fund at the end of the period, d_e is the amount of the quarterly deposit, r_e is the rate of return earned on the fund, and n is the number of quarters which have elapsed. At the end of the useful life of the nuclear plant, the fund must equal an amount which, combined with the

interest earned during the decommissioning period, will be sufficient to pay the costs of decommissioning. This amount is given by the standard annuity withdrawal formula:

$$15) \qquad E_2 = \frac{p[1-(1+r_e)^{-m}]}{r_e}$$

where E_2 is the required amount in the fund at the end of the plant life, p is the periodic payment for decommissioning costs, and m is the number of periods over which decommissioning is accomplished. The simulations used for the analyses in this report all assume that decommissioning is accomplished over a one-year period and is paid for by four equal quarterly payments. This is an unrealistic assumption, since even immediate dismantlement of the nuclear plant would require several years, but it is used to simplify the analysis and focus the discussion on the effects of tax policy over the plant life.

Under the external sinking fund approach, the taxes paid on the annual decommissioning charge conceptually could be handled in one of two ways. The taxes could be borne by the utility company and normalized in a procedure similar to that used for negative salvage value depreciation. Alternatively, the taxes could, in effect, be borne by the external sinking fund so that the deposit into the fund by the company is on an aftertax basis compared to the decommissioning charge paid by customers. Since the latter approach is the one actually in use by those utilities with external funds, it is the one assumed in the model. This procedure can be represented as follows:

$$16) \qquad R_3 = r[V - \sum D + w] + D + d_e + C + T_3$$

$$17) \qquad T_3 = t(R_3 - D - d_a - C - u_1)$$

where d_e is the actual amount of the deposit into the external fund [solving equations 16 and 17 and comparing to equation 8 reveals that utility revenues

actually increase by $d_e/(1-t)$]. Since the decommissioning fund is external to the company, in this case the amount of interest paid by the company is unchanged from the base case.

If the tax law were amended to permit the current deduction of decommissioning charges, d_e would replace d_a in equation 17 and the increase in utility revenue requirements would equal d_e rather than $d_e/(1-t)$. In this case, the tax deduction at the time of decommissioning would equal the actual cost of decommissioning minus the deductions previously allowed with regard to additions to the decommissioning reserve. Hence, d_e both depends on and determines the amount which must be funded by the decommissioning reserve, and must be solved for simultaneously.

The third funding procedure is an internal sinking fund. This procedure is similar to an external fund except that the fund is maintained by the utility and is invested in its assets. The fund is assumed to earn a return at the utility's rate of return, and, thus, there is no adjustment to the utility's rate base. The difference between this case and the external sinking fund is that the internal sinking fund substitutes for external capital and, therefore, the utility's interest payments decline. This, in turn, causes an increase in the utility's tax payments because of the lower interest deduction. These relationships may be represented as follows:

18) $R_4=r[V-\sum D+w]+D+d_i+C+T_4$

19) $T_4=t(R_4-D-d_a-C-u_4)$

20) $M_4=ai[V-\sum D+w-F]$

where d_i is the amount of the deposit into the internal fund and F is the amount of the fund. If the tax law were amended to permit the current deduction of decommissioning charges, d_i would replace d_a in equation 19.

The computer model constructed to derive the results shown in section IV uses the above equations to simulate the effects of the alternative tax policies on utility revenues, tax payments, cash flows, and the required intermediate variables each year over the life of the nuclear plant.

98TH CONGRESS
1ST SESSION

H. R. 2820

To amend section 162 of the Internal Revenue Code of 1954 with respect to allowing a deduction for additions to reserves established for decommissioning costs associated with nuclear powerplants.

IN THE HOUSE OF REPRESENTATIVES

APRIL 28, 1983

Mr. GIBBONS (for himself, Mr. MATSUI, Mr. VANDER JAGT, Mr. SCHULZE, Mr. THOMAS of California, Mr. FAZIO, Mr. FRENZEL, and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend section 162 of the Internal Revenue Code of 1954 with respect to allowing a deduction for additions to reserves established for decommissioning costs associated with nuclear powerplants.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DEDUCTION FOR DECOMMISSIONING COSTS ASSOCIATED WITH NUCLEAR POWERPLANTS.

Section 162 of the Internal Revenue Code of 1954 (relating to trade or business expenses) is amended by redes-

ignating subsection (j) as (k), and by inserting after subsection (i) the following new subsection:

"(j) DECOMMISSIONING COSTS.—

"(1) IN GENERAL.—The deduction allowed by subsection (a) shall include an addition to a reserve for the decommissioning costs to be incurred by a regulated public utility in connection with a nuclear powerplant. The term 'decommissioning costs' includes expenditures associated with those activities that relate to the retirement of a nulcear powerplant and which are recognized by the regulatory body having ratemaking jurisdiction over the taxpayer in establishing the standards for determing the amount of reserve addition referred to in paragraph (2) of this subsection.

"(2) LIMITATION.—The deductions allowed by paragraph (1) of this subsection shall be allowed only to the extent of the amount which the regulatory body having ratemaking jurisdiction over the taxpayer permits as an addition to a reserve which is recorded in the taxpayer's regulated books of account for the taxable year and which is included in its cost of service for ratemaking purposes.

"(3) RESERVE.—For purposes of this subsection, the term 'reserve' includes a balance sheet account in the taxpayer's regulated books of account in connection

with decommissioning costs or any fund created to pay decommissioning costs.

"(4) TREATMENT OF RESERVES.—Reserves that result from the allowance of deductions provided by paragraph (1) of this subsection shall be charged with those expenditures for decommissioning costs that are recognized by the appropriate regulatory authority in authorizing use of the reserves. Any reserve amounts that are in excess of decommissioning costs that are chargeable thereto shall be restored to income in the taxable year in which the existence of such excess is determined by the appropriate regulatory authority.

"(5) PREEXISTING RESERVES.—To the extent that a reserve for decommissioning costs was established prior to the effective date of this subsection and without allowance of a deduction, appropriate reserve charges shall first be made to such preexisting reserve to the extent of its balance on such effective date and shall be deductible in the year when paid or incurred without regard to this subsection.

SEC. 2. EFFECTIVE DATE.

The amendments made by section 1 shall apply with respect to taxable years beginning after December 31, 1982.

Chairman RANGEL. Al Noftz.

STATEMENT OF AL NOFTZ, EDISON ELECTRIC INSTITUTE, DIRECTOR OF TAXES, COMMONWEALTH EDISON CO. OF CHICAGO

Mr. NOFTZ. You have my written statement on behalf of our institute, but I shall digress from it because I believe I must respond to some of the statements that Mr. Pearlman made this morning.

Chairman RANGEL. Your full statement will appear in the record.

Mr. NOFTZ. Thank you, sir.

First, let me say that I am pleased that Mr. Pearlman recognizes that there are special problems with nuclear decommissioning costs, and that they require special solutions, we agree. Second, we utilities believe that all of our expenses should be recovered from all of the consumers of electricity who enjoy the benefits of a related asset. We believe that costs should not be borne by one generation of consumers at the expense of another generation of consumers.

Thus, nuclear decommissioning costs should be charged equitably to today's consumers as well as tomorrow's. That is a point that Mr. Pearlman did not address.

Third——

Mr. GIBBONS. Repeat that again, please.

Mr. NOFTZ. I was saying that we should equitably spread the costs of nuclear decommissioning to today's consumers as well as tomorrow's so we do not hit tomorrow's consumers with the entire amount of nuclear decommissioning costs.

Third, I must point out that many utilities presently are recovering accrued nuclear decommissioning costs from their consumers. They are permitted to do this by their regulatory commissions, and one must believe that regulatory agencies will not permit a utility to collect in its charges for electricity amounts to be used for future decommissioning costs that do not recognize the time value of money.

Most regulatory commissions do use some form of time valuing, such as recognition that the funds collected from today's customers for accrued decommissioning costs are invested and generate earnings prior to the time that the costs are actually to be incurred.

Furthermore, and in line with the time-value concept, H.R. 2820 will permit income and expense to be properly matched. That is, at present utilities are paying tax on amounts recovered from consumers for accrued decommissioning costs, but they have not been permitted by the IRS an offsetting, matching deduction for those costs. We must also recognize that amounts that will be deductible under H.R. 2820 will be spread over the life of the nuclear plants. There will not be a one-time windfall to the utilities.

Fourth, Mr. Pearlman indicated that he believes amounts that will be deductible for accrued nuclear decommissioning costs under H.R. 2820 will be overstated, because regulatory commissions have a vested interest in reducing the income tax payments of the utilities. I beg to differ. Regulatory commissions are independent governmental agencies that set rates after open public hearings and they certainly try to protect the interests of the consumer. The reg-

ulators do not want to impose artificially high charges for electricity.

Fifth, Mr. Pearlman stated that H.R. 2820 does not provide for the treatment of excess reserves, that is, he stated that excess amounts of accrued decommissioning costs recovered from customers will not be, or—I am not saying that correctly. He said there would be no recapture provision for any excess amounts recovered from customers, and that it would accrue to the benefit of the utilities. That is not true. I will read from the measure on page 3, lines 8 through 12, quote:

> Any reserve amounts that are in excess of decommissioning costs that are chargeable thereto shall be restored to income in the taxable year in which the existence of such excess is determined by the appropriate regulatory authority.

Therefore, there is recapture, it is in the measure.

Mr. Pearlman implied that the matter of the deduction of the accrued expenses is something new and that the problems that the IRS is having with them is of relatively recent vintage. While the decision of the Tax Court in *Ohio River Collieries* is fairly recent, the two other reclamation cases, *Denise Coal* and *Harold* were decided by the Third and Fourth Circuit Courts of Appeal in the 1950's.

Let me conclude by saying that we at Edison Electric Institute urge your support of H.R. 2820.

[The prepared statement follows:]

STATEMENT OF AL NOFTZ, DIRECTOR OF TAXES, COMMONWEALTH EDISON CO. OF CHICAGO, ON BEHALF OF THE EDISON ELECTRIC INSTITUTE

My name is Al Noftz. I am Director of Taxes for Commonwealth Edison Company, which provides electric service to about three million customers in the City of Chicago and northern Illinois, and Co-Chairman of the Tax Analysis and Research Subcommittee of the Taxation Committee of the Edison Electric Institute. I am privileged to submit this testimony on behalf of the Edison Electric Institute (EEI). EEI is the national association of investor-owned electric utilities in the United States. The member companies of EEI serve 99 percent of the ultimate customers of the investor-owned segment of the industry, comprising 77 percent of all electricity users in the country.

EEI appreciates the opportunity to comment on the timing of taxpayer deductions. Specifically, I shall testify on the deductibility on a current basis of accrued nuclear decommissioning costs.

Overview

Decommissioning, as it applies to an electric utility, relates to the dismantling, mothballing, or entombing of a nuclear-powered electric generating plant after its useful life has ended. Federal regulations require that the owner of a nuclear plant assume the responsibility for the decommissioning of the nuclear plant before the nuclear reactor is licensed by the Nuclear Regulatory Commission (NRC), although specific funding requirements for decommissioning are left to the states. If a nuclear power plant is not properly decommissioned, the health and safety of the public could be jeopardized. The potential effects of radioactive contamination from a retired nuclear plant are of such magnitude that prevention of such an occurrence is of great national importance. Thus, by virtue of its operating license, an operator of a nuclear power plant has a legal duty, which includes decommissioning, to protect the health and safety of the general public.

Many public utility regulatory commissions have responded to the federal requirement by recognizing the need for utilities to be financially able to decommission nuclear plants. They have faced this matter by allowing provisions for accrued decommissioning costs to be recovered in a utility's rates for electricity in a manner that will result in such costs being equitably recovered from customers over the economic life of a nuclear plant. These regulatory commissions recognize that the obligation to decommission arises from the operation of a nuclear reactor and that accrued decommissioning costs are equivalent to fuel costs, maintenance costs, and other production costs of a nuclear plant and that they should be recovered from customers as part of the cost of service in operating the plant.

Present tax law has been interpreted by the Internal Revenue Service in a manner that treats amounts collected from customers for accrued decommissioning costs as income that is subject to tax on a current basis with the corresponding tax deduction delayed until the decommissioning costs actually are incurred. Consequently, according to the Internal Revenue Service, without enabling legislation a deduction for decommissioning costs is not available during the life of a nuclear plant.

H.R. 2820, introduced by Congressman Gibbons, will provide for the deduction, on a current basis, of accrued decommissioning costs to the extent that such costs have been allowed by regulatory agencies and recovered from customers. The enactment of H.R. 2820 will eliminate a basic inequity and will be in line with the Treasury Department's concept of the time valuing of deductions in that most regulatory agencies will not permit a utility to collect in its charges for electricity amounts to be used for the future decommissioning of a nuclear power plant without the recognition of the time value of money. Otherwise stated, most regulatory agencies do use some form of time valuing, such as recognition

that the funds currently collected from customers for accrued nuclear decommissioning costs are invested and generate earnings prior to the time that decommissioning expenditures are to be incurred. In addition, income and expense will be properly matched. That is, while utilities have been paying income tax on amounts recovered from customers for accrued nuclear decommissioning costs, they have not been permitted an offsetting, matching deduction for the accrued decommissioning costs.

Current Deductibility Is Economically Correct

The emphasis of my comments is on the practical consequences to consumers and to electric utility companies of the non-deductibility of accrued decommissioning costs, but I should like to point out that a deduction on a current basis produces an economically correct result. This is demonstrated in a very recent article by Emil Sunley, former Deputy Assistant Secretary of the Treasury for Tax Analysis. I shall not attempt to describe Mr. Sunley's analytical approach, but I commend his article to you. A copy of the article is attached to these comments as an exhibit.

Consumers Bear Burden

The inequity of not being able to deduct accrued decommissioning costs on a current basis bears heavily on utility consumers in several respects. In some instances, utilities are allowed by their regulatory commissions to collect enough revenues from the consumers to cover not only the accrued decommissioning costs but also the income tax on those revenues. Thus, a consumer pays nearly $2 to cover $1 of accrued nuclear decommissioning costs. These customers very well may never realize the tax benefits from being able to deduct these costs when they are incurred by the utility company at the end of the plant's life. In other in-

stances, where income tax is not recovered from consumers on charges for accrued decommissioning costs and the federal income tax burden is assumed by the utility company, the customers may be somewhat better off in the short run but ultimately will have to pay for the company's increased financing costs that result from the payment of this tax burden. In either case, a deduction on a current basis for accrued decommissioning costs would ameliorate the inequities to customers that presently exist.

There are a number of nuclear generating companies that are single-asset companies. The nuclear plant is their sole earning asset. When the plant stops generating electricity, the company's income also will stop. At the time of decommissioning, there will not be any taxable income available to offset the decommissioning costs as they are incurred. Except for the possibility of recovering such amounts by means of net operating loss carrybacks, the taxes paid in prior years on the accrued decommissioning costs, which have been recovered from customers, will be permanently lost. The deductibility of accrued nuclear decommissioning costs on a current basis would avoid this inequity to the consumers of electricity. This same phenomenon may exist for other utility companies if their net taxable earnings from continuing operations are insufficient to utilize the deductions arising from decommissioning costs when they are incurred. As a result, there will be less assurance that funds will be available for the costs of decommissioning, and such costs, therefore, may be left to be paid by many customers who will never receive benefits from the nuclear plant.

H.R. 2820

H.R. 2820 would remove the inequity to consumers of electricity by:

- Allowing deductions on a current basis during the useful life of nuclear power plants for estimated

future decommissioning expenditures; and

- Limiting such deductions to amounts that regulatory agencies, after full hearings that include other interested parties, allow to be added to reserves for decommissioning expenditures and which are reflected in rates for electricity.

It especially should be noted that if at any time reserve amounts for decommissioning costs are determined to be in excess of the amount necessary to pay for the decommissioning, then such excess amounts are to be included in the utility's income and be subject to tax.

Summary

If utilities are not able to deduct accrued decommissioning expenses on a current basis, consumers of electricity will bear the burden of added charges for nuclear decommissioning costs. Additionally, deductibility of accrued decommissioning costs on a current basis will help to provide the necessary funds to accomplish the decommissioning. Furthermore, if accrued decommissioning expenses cannot be deducted on a current basis, there may be an inequality of charges between different generations of consumers of electricity.

Legislation such as H.R. 2820 will relieve the unfair burden of increased charges to customers. The federal statutes for licensing nuclear power plants require the preservation of the public health and safety. To fulfill that requirement, nuclear power plants must be decommissioned. Decommissioning is not elective. It is a necessary expenditure, for which many utility companies are collecting funds from consumers in charges for electricity. In such cases, regulatory commissions have recognized the federal requirements and treat accrued decommissioning expenses as an expense of the operation of the nuclear plant. Recog-

nition of accrued decommissioning costs as a deduction on a current basis for federal income tax purposes will provide for consistent treatment of nuclear decommissioning costs by the NRC, the IRS, and state regulatory commissions. An income tax deduction for accrued decommissioning costs is not only economically correct but will result in more equitable distribution of tax benefits to current and to future consumers of electricity and help to assure that funds will be available for the eventual decommissioning. Most important, H.R. 2820 will give consumers the full value of their payments for decommissioning charges.

My telephone number is (312)294-8575, and my mailing address is Commonwealth Edison Company, Post Office 767, Chicago, Illinois 60690.

Attachment

EXHIBIT

OBSERVATIONS ON THE APPROPRIATE TAX TREATMENT OF FUTURE COSTS

by Emil M. Sunley

Emil M. Sunley is Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells in Washington, D.C. He served as Deputy Assistant Secretary of the Treasury for Tax Analysis from 1977 to 1981.

In this article, Sunley critiques recent Treasury testimony relating to the tax treatment of mining reclamation costs and loss deductions claimed by casualty insurance companies. As Sunley points out, the questions raised by that testimony have important implications for similar questions arising in connection with the tax treatment of expenditures for product liability and warranty claims, nuclear power plant decommissioning costs, and the costs of dismantling offshore oil rigs.

While agreeing that the Treasury's analysis of future cost issues is correct in the case of ordinary business expenses, Sunley concludes that Treasury is incorrect when a future payment is an investment outlay that must be incurred if income is to be earned currently. He also concludes that Treasury's analysis of the appropriate tax treatment of casualty insurance companies is incomplete.

Recent Treasury testimony has focused on the time value of money in determining the appropriate tax treatment of certain future payments. For example, Treasury has opposed mining companies taking a current deduction for estimates of future reclamation payments.[1] Treasury has also opposed casualty insurance companies taking a current deduction for future outlays.[2] Instead, Treasury has suggested that delaying the deduction until the expense is actually paid always produces the correct result. Alternatively, Treasury has suggested that taxpayers could be allowed a current deduction for the discounted amount of the future outlay. The future outlay would be discounted at the after-tax discount rate, and no further deduction would be allowed.

[1]Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on December 7, 1982, before the Subcommittee on Energy and Agricultural Taxation of the Senate Finance Committee. See also, the Statement of William S. McKee, Acting Deputy Assistant Secretary of the Treasury (Tax Policy), on May 23, 1983, before the same subcommittee.

[2]Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), on June 13, 1983, before the Senate Finance Committee.

The Treasury testimony has broad implications not only for the tax treatment of mining reclamation expenses and casualty insurance liabilities, but also for the tax treatment of expenditures for product liability and warranty claims, costs of decommissioning nuclear power plants, and the costs of dismantling offshore drilling rigs.

The general thrust of the Treasury testimony on the "premature accrual" of future liabilities has been accepted by the Joint Tax Committee. Last June in a pamphlet prepared for the Finance Committee, the Joint Committee suggested that the

> "accrual rules could be amended to provide that an expense is not currently deductible unless the recipient of the payment is known and the taxpayer has a present liability to make the payment. Another alternative would be to require taxpayers to report certain deferred payment transactions using the cash method of account."[3]

The Committee on Taxation of the New York City Bar Association also recently examined the tax treatment transactions involving deferred payment of accrued liabilities.[4] The Committee concluded that (1) substantial economic distortions may be produced under existing law in some important cases, (2) this subject deserves urgent attention, and (3) legislative solutions may be required.

In this paper, no attempt is made to provide a comprehensive survey of the appropriate tax treatment of future outlays. Instead, the focus is on the analysis contained in the Treasury testimony relating to mining reclamation and casualty insurance. To anticipate the conclusion, the

[3]Joint Committee on Taxation, "Background on Tax Shelters," Joint Committee Print, June 23, 1983, p. 18.

[4]Committee on Taxation of the Association of the Bar of the City of New York, "Transactions Involving Deferred Payment of Accrued Liabilities: Federal Income Tax and the Time Value of Money," *Tax Notes* (August 29, 1983), pp. 699-714.

Recent Treasury testimony on mining reclamation and casualty insurance has confused the issue of the appropriate tax treatment of future costs.

Treasury (and the Joint Committee) analysis is correct when the future payment is an ordinary and necessary business expense, but the analysis appears to be incorrect when the future payment is an investment expenditure that must be incurred in the future if income is going to be earned currently. Moreover, the Treasury analysis of the appropriate tax treatment of casualty insurance companies is incomplete, and incorrect, because consideration was not given to the appropriate tax treatment of the insured.

What follows is a simple example of an investment that yields positive cash flow for a number of years and then requires a significant outlay at the end. The example is used to examine the appropriateness of alternative tax treatments of the final outlay. This example could represent an investment in surface mining, a nuclear power plant, or an offshore oil rig.[3] These investments have significant negative salvage value; that is, the costs paid at the end for reclaiming, decommissioning, or dismantling exceeds the value of the salvageable materials. It should be noted that the positive cash flows cannot be earned without incurring the negative outlay at the end. For example, to obtain the positive cash flows from a nuclear power plant the plant must be turned on. Once it has been turned on, some type of decommissioning will be required at the end of its operating life. Similarly, once land has been disturbed by surface mining, state and federal environmental laws require mining companies to reclaim it.

Consider a $3,000 investment that yields positive cash flow of $1,000 per year for five years and then requires "dismantling" expenses of $1,401. This investment in a world without taxes would have an internal rate of return of 10 percent as shown below.

TABLE 1

Year	Cash Flow	Present Value (r = .10)
1	$1,000	$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
6	-1,401	-790.82
		$3,000.00

Economic Depreciation

The issue concerns the appropriate tax treatment of the final outlay of $1,401. Treasury has argued that this outlay should be expensed in the year paid. I suggest that a proper matching of income and expense requires that the final outlay be "depreciated" over the life of the investment. Tax depreciation (or capital recovery) is neutral, as Paul Samuelson has shown, if (and only if) the true loss of economic value is permitted as a tax-deductible depreciation expense.[4] Moreover, if economic depreciation is allowed, the effective tax rate is equal to the nominal tax rate.

Economic depreciation can be determined by discounting for each year the remaining before-tax cash flow to the beginning of that year using the before-tax discount rate.[5] Economic depreciation is then equal to the change in the present value of the future cash flow.

TABLE 2

Year	Cash Flow	Present Value of Future Cash Flow Discounted to Beginning of Year (r = .10)	Depreciation*
0	-$3,000	$3,000.00	
1	1,000	2,299.95	$700.05
2	1,000	1,529.95	770.00
3	1,000	682.95	847.00
4	1,000	-248.77	931.72
5	1,000	-1,273.64	1,024.87
6	-1,401	-1,401.00	127.36
			$4,401.00

*Equal to the change in the present value of the future cash flow.

The interpretation of the third column of Table 2 is fairly straightforward. At the end of year 0, someone would pay $3,000 for this investment. At the end of year 1, once the first $1,000 of positive cash flow has been realized, someone would pay only $2,299.95 for the future cash flow. At the end of year 4, the value of the future cash flow has become negative. That is, the owner of the investment would have to pay someone to take the investment off his hands. The reason for this, of course, is that the present value of the future detriment (the $1,401) is greater than the present value of the future positive cash flow—the $1,000 at the end of year 5.

The Treasury...analysis is correct when the future payment is an ordinary and necessary business expense, but the analysis appears to be incorrect when the future payment is an investment expenditure....

It should be noted in the last column of Table 2 that economic depreciation permits $4,401 of capital recovery over the life of the project. Put another way, economic depreciation spreads the $3,000 initial investment plus the $1,401 final outlay over the life of the investment. One might view this result as similar to what accountants call "negative salvage value depreciation" where the depreciable basis is equal to original cost less salvage value. If the salvage value is negative, the depreciation allowed over the life of the investment is greater than the original cost. It is equal to the original cost plus the negative salvage value.[6]

[3]It does not represent the case of casualty insurance, which is discussed later.

[4]Paul A. Samuelson, "Tax Deductibility of Economic Depreciation to Insure Invariant Valuations," *Journal of Political Economy* (December 1964).

[5]It can also be obtained by discounting the after-tax cash flow by the after-tax discount rate.

[6]Whether negative salvage value depreciation would be neutral would depend on the timing of these deductions, not just the amount.

Table 3 demonstrates that if economic depreciation, as calculated in Table 2, is allowed, the effective tax rate is just equal to the nominal tax rate. For purposes of Table 3, a 50 percent tax rate is assumed. The after-tax rate of return is now 5 percent, which is just half of the 10 percent before-tax rate of return.

TABLE 3

Year	Before-Tax Cash Flow	Economic Depreciation*	After-Tax Cash Flow**	Present Value (r = .05)
1	$1,000	$700.05	$850.02	$809.54
2	1,000	770.00	885.00	802.72
3	1,000	847.00	923.50	797.77
4	1,000	931.72	965.86	794.26
5	1,000	1,024.87	1,012.44	793.26
6		127.36	63.68	47.52
6	-4,944			-$1,045.43***
				$3,000.00****

*Equal to the change in the present value of the future after-tax cash flow.

**Equal to (1-m)R + mD, where m is the marginal tax rate, R is the before-tax cash flow, and D is economic depreciation which is also the depreciation allowed for tax purposes.

***Equal to the present value of $1,401 discounted at 5 percent. The final outlay has no tax effect inasmuch as it has been depreciated over the life of the investment.

****The present value of the cash-flow is just equal to the initial investment.

The Appendix, *infra*, further explores the appropriate tax treatment of an outlay for mining reclamation or nuclear decommissioning. The criterion in the Appendix is neutrality between a normal investment (where the investment outlay is made only at the beginning of the project) and a negative salvage value investment (where a significant outlay is made at the end of the project).

Expensing—The Treasury View

The Treasury, as indicated above, maintains that expensing is the appropriate tax treatment of a required final outlay such as the cost of mining reclamation.[9] The Treasury argument, however, is faulty. Treasury's criterion for the appropriate tax treatment is a rule which would ensure that the amount charged by the seller reflects no more than the resource cost of completing the transaction. Treasury first assumes that in a world without taxes the discount rate is "r." When taxes are introduced, Treasury makes a fatal error when it assumes that the *after-tax* discount rate in the world with taxes is the same as the discount rate in the world without taxes. This assumption forces the conclusion that expensing or its equivalent (in present value terms) is required if the amount charged by the seller is not going to rise.[10] Expensing or its equivalent ensures that the before-tax and after-tax rates of return are equal. The effective tax rate is zero.

In contrast, if Treasury had assumed that the after-tax discount rate falls to (1-m) times the discount rate in the world without taxes where "m" is the tax rate,[11] Treasury would have concluded that the cost of the final outlay should be spread over the life of the investment in the pattern of economic depreciation.

Casualty Insurance

The Treasury Department has applied its analysis of the time value of money to the issue of the appropriate tax treatment of the liabilities of casualty insurance companies.[12] Treasury concluded that the current tax rules which permit insurance companies to deduct the undiscounted estimate of their future claims are seriously flawed. According to Treasury, two alternative approaches should be considered. One method would be to defer the deduction until the insurance company actually pays the claim. Another would be to limit the deduction for unpaid losses to the discounted present value of the future payments.

Treasury supports its conclusion with a technical appendix which is a reworking of the appendix from the mining reclamation testimony. This appendix, however, is not applicable to the insurance case.

Casualty insurance in the simplest case involves the payment of a premium to cover losses incurred during the year. The actual payment of claims may be made over a period of years.[13] A reasonable tax treatment of casualty insurance must recognize that a loss has taken place during the year of the insurance coverage. For a proper matching of income and expense, that loss should be deductible by someone that year.[14]

Consider first a world without insurance. In order to stay in business, companies would have to set prices for their products at levels sufficiently high to cover expected casualty losses. Some companies would have actual losses, and these losses would be deductible for tax purposes. When all companies are considered together, however, the amount charged customers (and included in taxable income) for expected casualties would just equal the amount deducted by companies that had actual casualty losses.

Now introduce casualty insurance but assume that the insurance companies pay their claims the same year the losses occur. Companies would have to set prices for their products sufficiently high to cover the premiums for casualty insurance. These premiums would be deductible

[9]See testimony of John E. Chapoton, December 7, 1982, particularly the Appendix to that testimony.

[10]Actually, if companies can borrow at the before-tax discount rate and interest expense is deductible for tax purposes, companies will be able to lower their prices in a world with expensing compared to the world without taxes.

[11]This assumption seems particularly appropriate if before-tax discount rate is equal to the cost of borrowed funds and interest is deductible. Investors will borrow at rate r as long as they can earn (1-m)r after taxes. It should be noted, however, that the before-tax discount rate in a world with taxes may be higher than the discount rate in a world without taxes. Even so, economic depreciation is required for the effective tax rate to be equal to the nominal tax rate.

[12]See testimony of John E. Chapoton, June 13, 1983. The Treasury may be rethinking this analysis.

[13]Casualty insurance typically does not provide that the insured party is covered for loss in present value terms. However, a policy could be written providing that in the event of a loss, the amount paid would equal the amount of the loss plus interest from the date of the loss. In this situation one would need to worry about the appropriate tax treatment of the interest income.

[14]Note that a taxpayer who self-insures may not be able to deduct the loss currently under the rules of accrual accounting because the amount of the loss cannot yet be determined with reasonabale accuracy. Also note that the discussion does not apply to structured settlements where the amounts paid exceed the amount of the loss.

for tax purposes but would be included in the taxable income of the insurance companies. Assuming all companies are in the same tax bracket, the tax savings from the deduction of the premium would just equal the tax paid by the insurance company on the premium income. The insurance company also would deduct the amount of claims paid which would just equal the amount of insured losses. The companies would not include the insurance proceeds in income, because the proceeds are just a reimbursement. Taking all companies together, it should be noted that the casualty losses are deducted for the year in which the loss occurs, just as in the world without insurance.

Consider now the two Treasury alternatives for the world where insurance companies pay out casualty claims over several years. If the deduction is deferred until the insurance company actually pays the claim, there is a mismatch between the time when the loss is incurred and the time at which someone, in this case the insurance company, is able to take a deduction for the loss. If, instead, the insurance company takes a deduction up front for the discounted present value of the future payment, the full amount of the loss is never deductible. The logical implication of the Treasury position would be to permit the insured, to the extent casualty losses are deductible, to take a current deduction for the difference between the claim payment expected in the future and the present value of that claim.[13]

These present value calculations could lead to significant IRS/taxpayer disputes. Current law, which permits a current deduction by the insurance company for the expected claim, probably is a workable procedure. Insurance premiums should be set to reflect the fact that the full loss is deductible by the insurance company and no part of the insured loss is deductible by the insured even though the claim is paid after a lapse of several years.

Conclusion

Recent Treasury testimony on mining reclamation and casualty insurance has confused the issue of the appropriate tax treatment of future costs. In the case of the mining reclamation testimony, Treasury, by assuming that the after-tax discount rate in a world with taxes is the same as the discount rate in a world without taxes, assumed its conclusion that delaying the deduction for mining reclamation costs until the expense is actually paid always produces the correct result. In the case of the casualty insurance testimony, Treasury failed to recognize that a casualty loss occurs during the year of the insurance coverage. That loss should be deductible that year if income and expenses are going to be matched properly.

[13]Under the IRS regulations (section 1.165-1(d)(2)), no portion of a loss with respect to which a reimbursement may be received is sustained until it can be determined with reasonable certainty whether or not such reimbursement will be received. Taxpayers are not allowed to deduct the loss when incurred and then later include the insurance proceeds in income.

APPENDIX

That a future outlay for mining reclamation or nuclear decommissioning should be written off over the life of the project may become clearer if one compares two investment projects—one a normal investment where the investment outlay is made only at the beginning of a project and the other a negative salvage value investment where a significant outlay is made at the end of the project.

For convenience, the two investment projects may be considered an underground mine and a surface mine. Both projects yield a positive cash flow of $1,000 per year for five years. The underground mine requires an initial investment of $3,790.80, but requires no outlay at the end of the project. The surface mine requires an initial investment of $3,000 and final mining reclamation expenses of $1,401, essentially the example used in Tables 1, 2, and 3. Both investments have a 10 percent before-tax rate of return.

Given these two investment projects, a mining company would be indifferent between them in a world without taxes inasmuch as they both would yield a 10 percent rate of return. Given that these two investments have the same before-tax rate of return, the tax law should not favor one over the other.

If tax depreciation is equal to economic depreciation then the after-tax rate of return for both projects will be the same and the effective tax rate will be equal to the nominal tax rate. Table 4 demonstrates that the underground mine example has a 10 percent before-tax rate of return. Table 5 derives economic depreciation for the underground mine example. It should be noted that the pattern of economic depreciation is the same for the underground mine as for the surface mine. (Compare the last column of Table 5 with the last column of Table 2.) In both cases the total investment—$3,790.80 for the underground mine and $4,401 for the surface mine—is written off over the life of the project. Finally, Table 6 shows that with tax depreciation equal to economic depreciation, the after-tax rate of return for the underground mine is equal to 5 percent, the same as the after-tax rate of return for the surface mine, as shown in Table 3.

What do we conclude from all this? A proper matching of income and expense requires that the cost of mining reclamation (or nuclear decommissioning or oil rig dismantling) be written off over the life of the project. Delaying the deduction until the expense is actually paid does not produce the correct result.

TABLE 4

Year	Cash Flow	Present Value ($r = 10$)
1	$1,000	$909.09
2	1,000	826.45
3	1,000	751.32
4	1,000	683.02
5	1,000	620.92
		$3,790.80

TABLE 5

Year	Cash Flow	Present Value of Future Cash Flow Discounted to Beginning of Year ($r = 10$)	Depreciation
0	-$3,790.80	$3,790.80	
1	1,000.00	3,169.88	620.92
2	1,000.00	2,486.86	683.02
3	1,000.00	1,735.54	751.32
4	1,000.00	909.09	826.45
5	1,000.00	0.00	909.09
			$3,790.80

Equal to the change in the present value of the future cash flow.

TABLE 6

Year	Before-Tax Cash Flow	Economic Depreciation[1]	After-Tax Cash Flow[2]	Present Value ($r = 10$)
1	$1,000.00	$620.92	$810.46	$771.87
2	1,000.00	683.02	841.51	763.27
3	1,000.00	751.32	875.66	756.45
4	1,000.00	826.45	913.22	751.32
5	1,000.00	909.09	954.54	747.89
				$3,790.80[3]

[1]Equal to the change in the present value of the future after-tax cash flow.

[2]Equal to $(1-m)R_t + mD_t$ where m is the marginal tax rate, R_t is the before-tax cash flow, and D_t is economic depreciation which is also the depreciation allowed for tax purposes.

[3]The present value of the cash-flow is just equal to the initial investment.

COVERAGE OF FUTURE COST ISSUES

For a special report by the Association of the Bar of the City of New York entitled "Transactions Involving Deferred Payment of Accrued Liabilities," see *Tax Notes*, August 29, 1983, pp. 699-714.

For news coverage of the December 7, 1982 hearing at which Treasury presented testimony regarding the tax treatment of mining reclamation costs, see *Tax Notes*, December 13, 1982, pp. 878-879.

For coverage of the June 13, 1983 Finance Committee hearing regarding the tax treatment of losses incurred by casualty insurance companies, see *Tax Notes*, June 20, 1983, p. 1110.

letters to the editor

GULF SAYS ROYALTY TRUSTS ARE LOSERS

Gentlemen:

This letter is in response to the letter entitled "In Defense of Royalty Trusts" submitted by Mr. J. F. Boros of Mesa Petroleum Company [See *Tax Notes*, February 13, 1984, p. 642.] As I am sure you are aware, Mesa has proposed that Gulf Oil Corporation spin off a royalty trust of approximately one-half of its U.S. oil and gas reserves. Gulf has concluded that there is little evidence to support the claims for value appreciation asserted in the Mesa proposal. On the contrary, we believe that the proposal, if adopted, would be detrimental to shareholder values because of: (1) the significant tax penalty that would be imposed on our individual shareholders upon distribution, (2) the severe economic damage that would be imposed on the remaining Corporation, and (3) the tremendous stock selling pressure that these factors would create.

The Mesa proposal incorrectly values the trust units and remaining stock by: (1) using misleading accounting procedures to recalculate Gulf's financial performance, (2) disregarding significant distinguishing characteristics among existing royalty trusts, (3) ignoring Gulf's prior trading history, and (4) dismissing significant adverse tax consequences by postulating perhaps the largest tax arbitrage in stock market history, which would require trading volumes for Gulf stock at unprecedented levels.

The myth that a royalty trust is all good things to all people is exposed by the discrepancy between Mr. Boros' allegation that there will be no revenue loss from the creation of a royalty trust and the statements of Mesa's Chairman, T. Boone Pickens, who is trying to sell royalty trusts on the basis that they will avoid federal income tax at the corporate level. Obviously, both of these Mesa spokesmen cannot be correct, and I am confident that when the Congressional revenue estimators complete their study they will confirm that the royalty trust proposed by Mesa would result in a substantial loss of federal tax revenues.

I am confident that...the Congressional revenue estimators...will confirm that the royalty trust proposed by Mesa would result in a substantial loss of federal tax revenues.

Of course, the entire tax scheme relating to royalty trusts depends on whether the IRS recognizes the avoidance of the corporate tax. At this time, there is reason to believe that the IRS will not condone such an avoidance scheme.

Very truly yours,

J. J. Ross
Chief Tax Officer
Gulf Oil Corporation

DRAFT

INITIAL SURVEY OF NUCLEAR DECOMMISSIONING -- REGULATORY TREATMENT OF FUNDING

An initial survey was conducted to determine the regulatory treatment of the funding of nuclear decommissioning. Due to the requirements for a quick response, survey procedures were informal. Therefore, the results can be considered preliminary.

The purpose of the survey was to determine the methodology used in the design of charges for nuclear decommissioning. There are three major funding methods.

- o An external fund managed by a trustee;
- o An internal fund managed by the company, but invested outside the utility. That is, the funds are not used for general corporate purposes; and
- o Negative salvage depreciation where funds are collected through depreciation charges, the funds are used for general corporate purposes and serve to reduce rate base except for the deferred taxes (debit) portion which remains in rate base.

There are a number of variants of the above methods, particularly the negative salvage depreciation method. These variants are listed in the "remarks" column.

There are five jurisdictions (including FERC) which use an external fund to collect charges for decommissioning. Five jurisdictions (including a FERC variant) use an internal fund. Fifteen jurisdictions use some form of negative salvage depreciation or a similar method. The commission which has not decided yet is considering an external fund.

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The survey results gave some indication of the extent of the consideration to which the time value of money is considered in the design of rates. Among the methods of allowing for the time value of money are the following:

- Allow the earnings of the fund to be credited to the fund so that the contributions of the earlier generations grow in value because of the earnings on the invested funds;
- Design the payments so that the charges to the earlier customers are discounted.

The majority of jurisdictions recognize the time value of money by allowing for the earnings of the funds in a reserve for decommissioning in the design of rates.

STATE	EXTERNAL FUND	INTERNAL FUND	NEGATIVE SALVAGE DEPRECIATION	PAYMENTS GRADUATED	PAYMENTS EQUAL	COMMENTS
AL			x	x		Decommissioning charge estimates updated periodically.
AR			x	x		Decommissioning charges are included in the fuel charge. Future estimated cost discounted for fund earnings. Company credits interest to fund net of deferred taxes.
CA	x			x		Based on estimated future cost. Commission has instructed utilities to establish external fund with tax-exempt treatment for the financing mechanism.
CO	x			x		Decommissioning charge is calculated as part of depreciation -- as a percentage of original cost in current dollars.
CT			x	x		Current dollars - updated periodically. (State laws are being enacted to guarantee availability of funds at time of decommissioning.) Trend is towards external fund or well-developed company fund.
FL		x			x	Commission has instructed utilities to establish separate account. Based on estimated future costs.
GA			x	x		---
IN	x			x		---
IA			x		x	Cost not escalated. Depreciation charges increased for decommissioning (1.4%). Funds reduce rate base but cumulated deferred taxes do not earn a return.
MD			x		x	Methodology is being reexamined in pending rate case which proposes an internal funded reserve.

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STATE	EXTERNAL FUND	INTERNAL FUND	NEGATIVE SALVAGE DEPRECIATION	PAYMENTS GRADUATED	PAYMENTS EQUAL	COMMENTS
MA		x		x		Segregated account in current dollars.
MI						Decommissioning charges are not collected. Commission is leaning towards an external fund.
MN		x		x		---
NJ			x		x	Costs are not escalated. Depreciation life shortened with earnings on difference applied to decommissioning fund.
NY			x	x		---
NC			x		x	Costs not escalated. Depreciation life shortened for purposes of calculating depreciation rate. However, the increased depreciation charges are collected over the normal depreciation life.
OH			x	x		---
OR			x		x	---
PA	x			x		---
SC			x		x	(See North Carolina)
SD		x		x		---
VA			x	x		Reserve does not reduce rate base and deferred taxes do not earn a return.
WV			x	x		(See Virginia)
MI			x		x	
FERC						Single asset companies
CT		x		x		
ME	x					
MA	x					
VT	x					

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Chairman RANGEL. We will hear from David Sweetland.

STATEMENT OF DAVID SWEETLAND, AMERICAN PUBLIC POWER ASSOCIATION, AND MANAGER, NORTH ATTLEBORO (MASS.) ELECTRIC DEPARTMENT, ACCOMPANIED BY FRANCES FRANCIS, COUNSEL

Mr. SWEETLAND. Mr. Chairman, members of the subcommittee, my name is David Sweetland, manager of the North Attleboro, Mass., Electric Department, speaking on behalf of the American Public Power Association which represents more than 1,750 publicly owned electric utilities across the country. With me today is Ms. Frances Francis from the Washington law firm of Spiegel and McDiarmid, and she has worked with the American Public Power Association on some amendments to this bill which we are discussing today.

The American Public Power Association strongly supports the intent of H.R. 2820 which would permit the current deduction of authorized payments to nuclear powerplant decommissioning funds by investor-owned utilities. However, this support is conditioned on changes to H.R. 2820 which we believe will improve the bill significantly.

Within the last 10 years, many publicly owned systems have entered into ownership agreements with private utilities to acquire a share of a nuclear powerplant, or purchase long-term entitlements in the output of such plants. Publicly owned utilities are committed to a responsible plan for decommissioning these plants when their useful lives end. However, public systems also are deeply committed to providing power to their customers at reasonable costs.

The present Internal Revenue Service interpretation that contributions to nuclear plant decommissioning funds are not currently tax deductible prevents many municipalities from achieving these objectives. This determination requires that today's consumers, including municipal systems purchasing nuclear-generated power, or municipal systems contributing directly to a decommissioning fund established by a privately owned utility, will contribute $2 for every $1 actually deposited in the fund. Over the life of a unit, this means the rates of these customers and public system owners could reflect twice the amount the fund actually needed for decommissioning purposes.

The impact of the IRS ruling is particularly onerous in the New England region. There are several single-asset nuclear power corporations in the area, some of which have filed for rate increases for decommissioning charges reflecting this tax impact without the normalization benefits which ratemaking principles could provide to consumers. In the case of the Vermont Yankee nuclear plant, customers of this one plant will pay in excess of $841 million in electric rates, of which $420 million will be used to pay Federal taxes, and the remaining $422.6 million will provide funds for the targeted decommissioning date of 2007.

Since coowners and ratepayers of companies with investments in nuclear powerplants are already paying substantially increasing costs for these facilities, APPA believes this legislation should be enacted to prevent further excessive rates from being collected.

APPA's support, however, is conditioned on the following amendments being adopted.

Income earned by an approved, separate decommissioning fund should not be subject to Federal taxes. This change would reduce by almost a third the amount to be collected from electric consumers over the lifetime of a nuclear plant;

Coowners, including publicly owned utilities, should be entitled to establish their own decommissioning funds;

If excess decommissioning funds are collected, they should not be subject to Federal taxes if they are returned directly to consumers; and

Only amounts authorized for decommissioning purposes by regulatory commissions should be deductible.

APPA believes these legislative changes will promote the goal of providing for the decommissioning of nuclear plants without unduly penalizing the operators of these units or the consumers and public system owners who take power from them. We urge the Congress to give favorable consideration of H.R. 2820 with these amendments. Thank you for the opportunity to testify.

[The prepared statement follows:]

STATEMENT OF DAVID SWEETLAND, ON BEHALF OF THE AMERICAN PUBLIC POWER ASSOCIATION

SUMMARY

The American Public Power Association (APPA), representing more than 1,750 local publicly owned electric utilities nationwide, strongly supports the intent of H.R. 2820, which would permit the current deduction of authorized payments to nuclear power plant decommissioning funds by investor-owned utilities. However, this support is conditioned on changes to H.R. 2820 which we believe will improve the bill significantly.

Within the last 10 years, many publicly owned systems have entered into ownership agreements with private utilities to acquire a share of a nuclear power plant, or purchase long-term entitlements in the output of such plants. Publicly owned utilities are committed to a responsible plan for decommissioning these plants when their useful lives end. However, public systems also are deeply committed to providing power to their consumers at reasonable costs.

The present Internal Revenue Service interpretation that contributions to nuclear plant decommissioning funds are not currently tax deductible prevents many municipaltities from achieving this objective. This determination requires that today's consumers, including municipal systems purchasing nuclear-generated power, or municipal systems contributing directly to a decommissioning fund established by a privately-owned utility, will contribute $2 for every $1 actually deposited in the fund. Over the life of a unit, this means the rates of these customers and public system owners could reflect twice the amount the fund actually needed for decommissioning purposes.

The impact of the IRS ruling is particularly onerous in the New England region. There are several single-asset nuclear power corporations in the area, some of which have filed for rate increases for decommissioning charges reflecting this tax impact without the normalization benefits which ratemaking principles could provide to consumers. In the case of the Vermont Yankee nuclear plant, customers of this one plant will pay in excess of $841 million in electric rates, of which $420 million will be used to pay federal taxes, and the remaining $422.6 million will provide funds for the targeted decommissioning date of 2007.

Since co-owners and ratepayers of companies with investments in nuclear power plants are already paying substantially increasing costs for these facilities, APPA believes this legislation should be enacted to prevent further excessive rates from being collected. APPA's support, however, is conditioned on the following amendments being adopted:

Income earned by an approved, separate decommissioning fund should not be subject to federal taxes. This change would reduce by almost a third the amount to be collected from electric consumers over the lifetime of a nuclear plant;

Co-owners, including publicly owned utilities, should be entitled to establish their own decommissioning funds;

If excess decommissioning funds are collected, they should not be subject to federal taxes if they are returned directly to consumers; and

Only amounts authorized for decommissioning purposes by regulatory commissions should be deductible.

APPA believes these legislative changes will promote the goal of providing for the decommissioning of nuclear plants without unduly penalizing the operators of these units or the consumers and public system owners who take power from them. We urge the Congress to give favorable consideration of H.R. 2820 with these amendments. Thank you for the opportunity to testify.

STATEMENT

Mr. Chairman, members of the subcommittee, my name is David Sweetland, and I am the manager of the North Attleboro, Massachusetts Electric Department. I am speaking on behalf of the American Public Power Association (APPA), the national service organization representing more than 1,750 local publicly-owned utilities nationwide.

APPA strongly supports the intent of H.R. 2820 which would permit investor owned utilities to deduct as current expenses certain payments made to nuclear power plant decommissioning funds. This legislation would reduce the already high costs of operating existing nuclear power plants and, in particular, the costs associated with the eventual decommissioning of these plants. APPA's support is conditioned, however, on certain amendments being made to H.R. 2820, reflecting the actual experience of its members in making payments to these funds.

I. The cause of the current controversy

This legislation responds to an interpretation by the Internal Revenue Service (IRS) preventing utilities from taking a current deduction for payments being made to nuclear power plant decommissioning funds now. Generally, these payments are made by utilities pursuant to agency orders, state law, or voluntary actions. The payments can be substantial. As an example, in a recent Federal Energy Regulatory Commission (FERC) case involving the Vermont Yankee nuclear power plant, these decommissioning costs were projected to total $841.2 million by the year 2007. Decommissioning itself would only cost approximately $422.6 million, or about half that amount if the fund were not taxed. For Maine Yankee, the estimated fund amount in 1983 dollars was $57 million. For Boston Edison's Pilgrim Unit, the commissioning cost with taxes is projected to be $323 million.

Until recently, the Nuclear Regulatory Commission (NRC) assumed that nuclear power plant decommissioning would not constitute a singnificant portion of their costs. Because of current developments, the amounts required for decommissioning will be so great that most utilities have begun, or are about to begin, collecting rates designated as decommissioning fund contributions. Since the funds will not actually be expended until plants cease commercial operations, some 15–30 years in the future, the IRS has indicated it will consider revenues paid to decommissioning funds during the year as ordinary income. The rate effect could be to require today's customers to pay nearly twice the amount needed to meet a fund's targeted level.

II. These costs will exacerbate the increasing costs of electricity, especially for customers currently served by nuclear power

The collection of higher rates for federal taxes must be viewed against the increasing costs which ratepayers and some public co-owners are already assuming to cover plant modifications required by post-Three Mile Island (TMI) regulations and new, higher charges associated with the permanent nuclear waste disposal program. (In some cases, the TMI-associated changes alone could exceed the book value of the original plant cost.)

When examined, however, it is evident that the decommissioning fund contributions represent, where placed in a separate or reserved fund, monies which utilities cannot use, except for that sole purpose. The IRS ruling creates additional tax burdens as the projected costs of decommissioning increases.

In the New England region, the impact of the ruling is aggravated by the organizational structure of several existing nuclear power plants. The region has several single-asset corporations which have filed for rate increases for decommissioning costs without reflecting the tax normalization benefits which should, under applica-

ble FERC regulations, mitigate the effects of the IRS' rulings. The cost differentials are dramatic. For example, in Vermont Yankee, the Company projected an estimated fund requirement of $422.6 million in 2007, the year in which the plant is expected to cease commercial operations. However, the effect of reflecting the federal tax component, without normalization, will result in a total dollar rate increase of $841.2 million or nearly double the funds actually needed to decomission the plant. Thus, it is evident that the issue at stake here will potentially cost hundreds of millions of dollars over the next few decades to New England consumers alone.

III. The interest held in approved funds should not be subject to federal taxes

In addition to the current deduction treatment sought in H.R. 2820, APPA recommends that interest earned by an approved fund not be subject to federal taxes. As long as a utility cannot commingle decommissioning funds with general revenues, and the funds are held solely for that purpose, these funds should be permitted to earn income without incurring federal taxation. The funds are effectively monies dedicated for a public purpose (i.e., the eventual decommissioning of nuclear power plants, without the certainty of knowing the exact amount of these costs). In a sense, today's consumers are providing funds to future consumers so the public will be assured that decommissioning is accomplished properly, unlike past situations, for example, where manufacturers freely dumped hazardous materials without considering the future costs of providing the safe burial of those substances. Because of the long interval between the time decommissioning costs are collected and are actually expended, the potential savings are considerable. In the case of Vermont Yankee, for example, eliminating the federal tax on interest earned would reduce the size of the required fund by one-third.

To achieve this, APPA recommends a new Section 2, as follows:

"SEC. 2 INTEREST EARNED ON RESERVES.

"Interest earned on Reserves shall, to the extent retained within the Reserves at all times and maintained solely for the purpose of paying future decommissioning costs, be exempt from federal taxes."

IV. Excessive collection of decommissioning funds should not be taxed if they are returned to consumers directly

Under Subsection (j)(4) of H.R. 2820, it would appear that if decommissioning funds included an amount exceeding its actual costs, that amount would be considered ordinary income and subject to federal taxation. This ignores these potential situations—state laws may require the excess in the fund, that is, amounts not actually spent on decommissioning, to be refunded in full to ratepayers (as is the case under Maine law); a state regulatory commission may order the excess amount to be refunded; or a utility may have a contractual agreement to refund excess amounts to its co-owners or co-participants. APPA sees no difficulty with treating the excess amount as ordinary income for tax purposes if the utility actually receives the funds and is free to use them as it wants. However, if the utility is required, or voluntarily agrees, to pass these excessive funds back to consumers or participating entities in toto, then APPA believes these funds should not be subject to federal taxes. Since these excess funds are effectively a loan from one generation of ratepayers to another, it is inequitable that repayment of the involuntary loan should result in a tax liability to the utility unless, of course, the excess is permitted to be a windfall to the utility in the year in which it is determined.

To accomplish this objective, we would recommend that the following words be added at the end of Subsection (j)(4): "and the excess becomes available for use by the taxpayer."

V. Only payments authorized by regulatory agencies should be allowed the current deduction treatment

It is clear that only decommissioning fund payments authorized by a rate regulating body should be permitted the current deduction treatment. H.R. 2820 provides, in Subsection 5(j) (1) and (4) that amounts "recognized" as decommissioning costs should be accorded this tax treatment. APPA proposes modifying this existing language by deleting "recognized" and substituting "approved as reasonable." This will again ensure that the collection of decommissioning funds is kept to reasonable levels.

VI. Co-owners should not be precluded from establishing their own decommissioning funds

The investment in nuclear power plants has been so great that, in many instances, no single corporate entity owns the entire facility. The diversity of owner-

ship has assisted the financing of these plants and reduced the risks for each participating entity (in contrast with those incurred from complete ownership in a very large unit). Similarly, APPA believes that nothing in this legislation should prevent more than one decommissioning fund from being established to qualify for the proposed tax treatment. In some states, regulatory commissions regulate the retail transactions of only private utilities, while municipal system activities are regulated by separate city commissions. Also, the activities of a utility owning a nuclear plant may be subject to a federal regulatory agency, while in other instances, its actions may be subject to both federal and state regulatory authorities. Whatever the regulatory framework, it is preferable that each participating entity, consistent with the goal of maintaining a timely-paid, adequate, and secure decommissioning fund, be permitted to track its own decommissioning obligations consistent with other laws and regulations.

This change can make a significant difference to a single system's customers. For example, the municipal owners of St. Lucie Unit No. 2 in Florida were informed initially that their contribution to the decommissioning fund and other related nuclear waste expenses would be approximately $600,000. After some negotiation with Florida Power and Light Corporation, the municipal owners established their own fund. Because of the tax differences, they were able to reduce their annual obligation to approximately $200,000. The level of the amount maintained in the fund, however, will match that collected by the private utility. Several municipal systems in New England attempted to secure the same benefits for their customers, but were precluded from doing so by the FERC, which required them to contribute to a single fund maintained by the private utility. *Ashburnham Municipal light Dept.* v. *FERC*, D.C. Cir. No. 82-2332, judgement issued June 1, 1983. Accordingly, this legislation should make it clear that where the decommissioning obligation follows the owner-participant, the proposed tax treatment should not be restricted to a single fund requirement for each nuclear unit. To this end, we would recommend a separate provision as part of Subsection (j)(3), as follows: Nothing in this section shall be interpreted to require that the reserve or fund must be a single reserve or single fund to qualify.

VII. Miscellaneous recommendations

Several states require decommissioning reserves be established in separate funds outside the utility's control (e.g., Maine Yankee's external fund has been established pursuant to a state law). Other utilities have voluntarily established separate, independent trust funds exclusively for nuclear decommissioning costs. For this reason, we would revise Subsection (j)(3) to read as follows:

"(3) RESERVE.—For purposes of this subsection, the term "reserve" includes a balance sheet account in the taxpayer's regulated books of account in connection with decommissioning costs or any separate fund established pursuant to federal or state law, or as a trust fund approved by the appropriate regulatory or governmental body to pay decommissioning costs."

Another contingency which should be addressed occurs if there is a shortfall in the reserve account. Where a licensee-taxpayer (in contrast to the reserve) recovers the shortfall from co-owners, including municipal systems, or other sources, there is a question of how these amounts should be treated. They are not additions to "reserves." To avoid treatment as ordinary "income," we would suggest a separate subsection, (1)(b), as follows:

"(1)(b) CAPITAL CONTRIBUTIONS.—Where a taxpayer receives contributions from joint participants or other sources, to provide for a shortfall in any specific reserve for decommissioning costs, these amounts shall not constitute income to the taxpayer, if the contributions are actually expended to decommission the nuclear plant."

VIII. Conclusion

Many unanticipated costs of a very substantial nature are being borne today by customers and owners of nuclear power plants. The industry, including the regulatory community, is struggling with the great cost uncertainties of maintaining and ultimately decommissioning these nuclear plants in the future. As standards and public expectations change, customers and owners of nuclear power plants must still confront the burden of producing reasonably priced power from plants which are on line today. Also, current customers are being required to pay for future uncertainties and these changed concerns. APPA supports the intent of H.R. 2820 because it attempts to maintain costs to today's customers of meeting those new and uncertain obligations. We also strongly recommend that the Committee consider the amendments we have suggested to ensure that this objective is met in a fair and equitable manner.

In closing, APPA respectfully requests that the attached resolution on this issue adopted by its Legislative and Resolutions Committee in February, 1984 and the marked-up copy of H.R. 2820 showing APPA's recommendations, be made part of the record.

Thank you for the opportunity to testify before the subcommittee on this issue.

TAX TREATMENT OF NUCLEAR POWER PLANT DECOMMISSIONING COSTS

Whereas, it is federal policy to require publicly and privately owned utilities who own nuclear power plants to provide funds for decommissioning cost, and

Whereas, many private utilities are currently collecting decommissioning costs from plant-co-owners or ratepayers pursuant to regulatory orders issued by the Federal Energy Regulatory Commission or state public utility commissions, and

Whereas, the Internal Revenue Service (IRS) has determined that co-owner or ratepayer contributions to decommissioning funds are not deductible until such expenses are actually incurred and, therefore, are current income subject to taxation in the year in which they are received, and

Whereas, the IRS determination may double the current costs that co-owners or ratepayers will pay for decommissioning nuclear power plants, and

Whereas, the interest earned on decommissioning funds is also taxable, further increasing the costs which co-owners and ratepayers will have to bear, and

Whereas, the IRS determination could be particularly inequitable to ratepayers served by private utilities whose sole assets are nuclear plants, such as Vermont Yankee, because when their plants cease operations, the companies will probably have no income against which to deduct decommissioning expenses, and

Whereas, publicly owned utilities who share ownership of nuclear plants should have the opportunity to fulfill their own obligations to pay decommissioning costs, and

Whereas, a bill, H.R. 2820, has been introduced to allow private utilities as current deduction for ratepayer contributions to decommissioning funds authorized by regulatory commissions,

Now, therefore, be it *Resolved:* That the American Public Power Association urges the Congress to enact legislation which would permit the treatment of monies received as co-owner or ratepayer contributions to nuclear power plant decommissioning funds authorized by regulatory commissions as current deductible expenses, and treat interest earned on such funds as tax exempt, and

Be it *further resolved:* That such legislation should provide publicly owned utilities who share ownership of nuclear power plants with the opportunity to establish their own decommissioning funds.

Adopted by the Legislative and Resolutions Committee of the American Public Power Association February 8, 1984, in Washington, D.C.

[H.R. 2820, 98th Congress, 1st sess.]

A BILL To amend section 162 of the Internal Revenue Code of 1954 with respect to allowing a deduction for additions to reserves established for decommissioning costs associated with nuclear powerplants

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DEDUCTION FOR DECOMMISSIONING COSTS ASSOCIATED WITH NUCLEAR POWERPLANTS.

Section 162 of the Internal Revenue Code of 1954 (relating to trade or business expenses) is amended by redesignating subsection (j) as (k), and by inserting after subsection (i) the following new subsection:

"(j) DECOMMISSIONING COSTS.—

"(1) (a) IN GENERAL.—The deduction allowed by subsection (a) shall include an addition to a reserve for the decommissioning costs to be incurred by a regulated public utility in connection with a nuclear powerplant. The term 'decommissioning costs' includes expenditures associated with those activities that relate to the retirement of a nuclear powerplant and which are approved as reasonable by the regulatory body having ratemaking jurisdiction over the taxpayer in establishing the standards for determining the amount of reserve adition referred to in paragraph (2) of this subsection.

"(1)(b) CAPITAL CONTRIBUTIONS.—Where a taxpayer receives contributions from joint participants or other sources, to provide for a shortfall in any specific reserve for decommissioning costs, these amounts shall not constitute income to the taxpayer, if the contributions are actually expended to decommission the nuclear plant.

"(2) LIMITATION.—The deductions allowed by paragraph (1) of this subsection shall be allowed only to the extent of the amount which the regulatory body having ratemaking jurisdiction over the taxpayer permits as an addition to a reserve which is recorded in the taxpayer's regulated books of account for the taxable year and which is included in its cost of service for ratemaking purposes.

"(3) RESERVE.—For purposes of this subsection, the term 'reserve' includes a balance sheet account in the taxpayer's regulated books of account in connection with decommissioning costs or any separate fund established pursuant to federal or state law or as a trust fund approved by a regulatory or governmental body to pay decommissioning costs.

"(4) TREATMENT OF RESERVES.—Reserves that result from the allowance of deductions provided by paragraph (1) of this subsection shall be charged with those expenditures for decommissioning costs that are approved as reasonable by the appropriate regulatory authority in authorizing use of the reserves. Any reserve amounts that are in excess of decommissioning costs that are chargeable thereto shall be restored to income in the taxable year in which the existence of such excess is determined by the appropriate regulatory authority [, and the excess becomes available for use of the taxpayer.]

"(5) PREEXISTING RESERVES.—To the extent that a reserve for decommissioning costs was established prior to the effective date of this subsection and without allowance of a deduction, appropriate reserve charges shall first be made to such preexisting reserve to the extent of its balance on such effective date and shall be deductible in the year when paid or incurred without regard to this subsection.".

SEC. 2. INTEREST EARNED ON RESERVES.

Interest earned on Reserves shall, to the extent retained within the Reserves at all times and which shall be applied, at least annually to reduce the total decommissioning charges imposed on the customers of the public utility or any owner utility, be exempt from federal taxes.

SEC. 3. EFFECTIVE DATE.

The amendments made by section 1 shall apply with respect to taxable years beginning after December 31, 1982.

Chairman RANGEL. This panel is joined by Ms. Sally Hindman, a nuclear analyst for the Public Citizen's Critical Mass Energy Project.

STATEMENT OF SALLY HINDMAN, NUCLEAR ANALYST, PUBLIC CITIZEN'S CRITICAL MASS ENERGY PROJECT

Ms. HINDMAN. Thank you, Mr. Chairman, I appreciate the opportunity to present the view of the Public Citizen's Critical Mass Energy Project.

We represent close to 5 million citizens. I will be talking about tax deductibility of funds for decommissioning, a subject of great importance both to concerned citizens and utilities today. We commend Representative Gibbons on recognizing the need for legislative action in this area.

If I may, I would like to summarize the main points of my written statement and submit this prepared statement for the record.

H.R. 2820 is a bill expected to provide millions in savings to utility customers. We believe the consumer benefit of not having to pay taxes on funds for future expense is important. But H.R. 2820, in its present form, makes no distinction as to the funding methods used by utilities to accrue funds for decommissioning.

We believe this is a key distinction which must be made in order that the bill be truly beneficial to ratepayers as a whole.

Therefore, we cannot support H.R. 2820 in its present form.

The present IRS opinion is that funds available to the utility for use as current income are taxed as current income. We agree with

this principle. External sinking funding requires that money be set aside separate from company assets. This money is not available for company use and would not therefore be a part of income to the utilities.

Internal unfunded reserves used today by companies in all but six States allow decommissioning funds to be available for the company's general use.

Funds are available as current income for tax purposes. No funds are actually set aside physically for decommissioning. Utilities plan to borrow the money needed at the time of decommissioning.

In considering the time value of money it is important to look at two things, the assurance provided by financing methods that funds will be available at the time they are needed, and also the future decommissioning scenario.

Internal unfunded methods have been described by Robert Wood of the NRC as so fraught with uncertainty as to be of marginal adequacy unless coupled with insurance or some other mechanism to increase the assurance provided.

The NRC found internal unsegregated financing methods to provide the least assurance of all methods studied that funds would be available for decommissioning.

The external sinking fund was found to provide much greater assurance of the availability of funds.

Although costs of external sinking funding would normally be twice the unfunded reserve, this cost differential is removed when the external fund receives a tax deduction if the unfunded reserve does not.

A study by Temple, Barker, and Sloan has found that of the possible financing options available to utilities, external sinking funding was the second most equitable after prepaying.

We don't support prepayment because of its high up-front costs. Equity to ratepayers is an important consideration as a number of people today have pointed out. The electricity produced-ratepayers benefiting from the electricity produced by a plant should be the ones to bear its costs.

According to DOE, 70 reactors will be inoperable by the year 2010. Due to the unavailability of a waste disposal site for high level wastes at the time of decommissioning, as well as several major factors, it is likely that plant dismantlement will be delayed 30 to 50 years after shutdown.

This means that the major portion of funds for decommissioning will be needed between 2040 and 2060, 60 to 80 years from today.

As Robert Wood of the NRC has stated, no matter what the current financial health of the utility is, financial solvency of any particular enterprise, or even the structure of the electric utility industry cannot be projected with confidence so far in the future.

Given the current financial instability of the utility industry, it would be irresponsible, we feel, to count on the ability of utilities to sell bonds cheaply in 60 to 80 years to finance decommissioning.

By not requiring external sinking funding mechanisms, we risk not only the potential for a Government bailout or ratepayer bailout for decommissioning in future years; we also risk the possibility for over 130 long-term, high-level radioactive waste sites.

As the NRC has shown, radioactivity will not decay to unconditional release levels within the foreseeable lifetime of any man-made structure.

The time value of money is certainly exaggerated by taking such risks.

We believe it is the Federal Government's responsibility to require funding provisions which insure that funds needed will be available for decommissioning. This is the only fair policy for all American taxpayers and ratepayers.

Utilities already receive significant tax subsidies through accelerated depreciation, investment tax credit, and other IRS provisions. With the U.S. deficit at an alltime high, it is a poor time for giving such large subsidies to utilities.

A tax deduction should only be allowed for a decommissioning finance option which will totally benefit ratepayers and taxpayers, and that is an external sinking fund.

In conclusion, as the bill under consideration now stands, it makes unacceptable demands on Americans to risk depending on utility borrowing power in 2050.

We believe it is in the interests of all Americans for utilities to be required to externally accrue funds for decommissioning. We would support H.R. 2820 with this modification.

Thank you.

[The prepared statement follows:]

STATEMENT OF SALLY HINDMAN, NUCLEAR ANALYST, PUBLIC CITIZEN'S CRITICAL MASS ENERGY PROJECT

Mr. Chairman and members of the House Ways and Means Committee, my name is Sally Hindman. I am nuclear analyst for Public Citizen's Critical Mass Energy Project. My business address is: 215 Pennsylvania Ave. SE, Washington, D.C. 20003. Public Citizen is a cor.3umer organization which works on energy, taxation, health and other issues of relevance to citizens.

Today I am testifying on behalf of Public Citizen's Critical Mass Energy Project and for 18 national and local organizations: Environmental Action, Inc., Environmental Defense Fund, Environmental Policy Institute, Florida Consumers Federation, Friends of the Earth, Illinois Public Action Council, Kansas Natural Resources Council, Massachusetts Public Interest Research Group, Minnesota Public Interest Research Foundation, Nuclear Information Resource Service, Public Interest Research Group in Michigan, Redwood Alliance, Sierra Clubm Union of Concerned Scientists, Vermont Public Interest Research Group, Vermont Yankee Decommissioning Alliance, Wisconsin Citizen's Utility Board, and Wisconsin's Environmental Decade.

We appreciate the opportunity to present the views of our organizations on tax deductibility of funds for decommissioning, a subject of great importance both to concerned citizens and to utilities today. Decommissioning is a major issue which needs to be addressed now. We commend Rep. Gibbons on recognizing the need for legislative action in this area.

H.R. 2820, a bill to amend Section 162 of the Internal Revenue Code with respect to allowing a deduction for additions to reserves established for decommissioning costs associated with nuclear power plants, is being discussed as beneficial to ratepayers and taxpayers as a whole. It would allow electric utilities to treat future decommissioning expenses as a current income tax deduction to the extent allowed in cost of service for rate-making purposes. In so doing it is expected to provide millions of dollars in direct savings to utility customers.

Today's hearing will examine the timing and measurement of taxpayer deductions for obligations to be paid in the future, including funds for decommissioning.

Our testimony will address tax deductibility of funds for decommissioning focussing on reasons why a change is required in order to make the bill equitable to ratepayers and taxpayers as a whole.

TAX DEDUCTABILITY OF FUNDS FOR DECOMMISSIONING

The current tax status of funds for decommissioning forces ratepayers to pay taxes today for a future expense. In fact, consumers are having to pay almost twice as much for decommissioning to shoulder this tax burden.

We believe the consumer benefit of not having the pay current taxes on funds for a future expense is important. But we do not support the bill in its current form because the recommended tax treatment does not distinguish between internal and external funding. We recommend that tax deductions for decommissioning expenses only be allowed for external sinking funds. This will help assure that decommissioning funds are available when needed.

THE NEED FOR A MODIFICATION IN THE BILL—EXTERNAL VERSUS INTERNAL FUNDING METHODS

Our concern is with the financing mechanism utilities would be encouraged to use to accrue funds for decommissioning if no distinction is made between methods allowed a tax deduction. The major financial methods are presently used by private utilities, external sinking funding and internal unsegregated methods. Most public utilities (non-investor owned) use an intermediate mechanism, an internal segregated fund. We believe that external sinking funding is the only method which should be eligible for a tax deduction.

The external sinking fund requires that money be set aside which is separate from company assets. These funds are sometimes managed by a bank as they are in Massachusetts for the Yankee Rowe plant. They can also be managed by the state as California has chosen to do. The major feature of this mechanism is that although funds are in the Internal Revenue Service's (IRS) view gross income to the corporation, they are not physically available to the utility for its use.

At present, external sinking funds are used in six states for accruing decommissioning monies: California, Colorado, Maine, Massachusetts, Pennsylvania, and Vermont.[1] This represents 15 units. New Hampshire has also made a decision that external sinking funding will be required for Seabrook if and when the plant goes on line.[2] External sinking funding has been considered in at least fifteen states to date.[3] In several cases utilities have supported this funding method. Companies supported external sinking funding in Michigan where a decision on external sinking funding is pending and in Pennsylvania, the first state to initiate external financing methods.[4]

An internal unsegregated reserve is an accounting treatment which generally consists of a financial provision in the depreciation rate for a nuclear plant representing the estimated cost of decommissioning. This is also known as "negative net salvage" depreciation.

Decommissioning funds are not in any way segregated from other company assets when this type of accounting system is used. These monies are freely available to the utility for use in new plant construction, or for practically anything like buying a tractor to mow the company's lawn. In short, internal unsegregated funds are available to the utility to use as current income for tax purposes.

In fact, this method is technically not really a decommissioning financing method, but more a means of collecting money from "today's " ratepayers ostensibly to pay for this future expense. No funds, however, are actually being set aside for decommissioning. Utilities plan to borrow the money needed at the time of decommissioning. Utilities in 19 states are currently using some form of this method.[5]

The internal segregated fund, although not generally allowing companies access to capital, has major cost disadvantages for ratepayers compared to internal unsegregated methods. Nuclear Regulatory Commission (NRC) economist, Robert S. Wood, believes such a method will not provide much greater assurance of the availability of funds for decommissioning than does the unfunded reserve.[6] For these reasons

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[1] Sally Hindman, "Decommissioning Policies for Nuclear Power Plants: A Critical Examination" (Washington, D.C.: Public Citizen, Inc. and Environmental Action Foundation, Forthcoming 1984).

[2] Ibid.

[3] Ibid.

[4] State of Michigan Public Service Commission, Proposal for Decision, Case No. V-6150, November 2, 1981.

[5] Sally Hindman, "Decommissioning Policies for Nuclear Power Plants: A Critical Examination."

[6] Personal communication with Robert S. Wood, U.S. Nuclear Regulatory Commission, February 16, 1984.

and because we are aware of only a handful of companies using it, we will not focus on this option in our discussion. However, under present IRS guidelines internal segregated funds would be treated as current income.

In considering whether to allow utilities a tax deduction on funds for decommissioning it is important to distinguish between those financing methods allowing companies access to these monies as current revenue and those which do not allow expenditure of these funds.

Allowing utilities to take an expense deduction for internal unsegregated reserves which are actually used as current revenue violates Section 162 of the Internal Revenue Code which defines "expenses" for tax purposes. Under the definition, expenses must be "paid or incurred during the taxable year." This definition has been further clarified by the courts in National Can Corporation vs. U.S. which states:

"In its most general acceptance, the term "expense," when used to determine tax deductions, means money spent; dispensing of money; drain on one's finances; incurring in the tax year of an obligation to pay; or employment and consumption of time and labor." (520 F. Supp. 567.)

If, on the other hand the utility places the funds in an external sinking fund, the money is not available as current revenue and can be legitimately considered an expense for tax purposes.

For this reason, it is vital that any deduction which utilities are allowed is not for funds which are used as current revenue. A deduction should only be allowed for funds held externally. Since these funds are not available for other purposes, a decommissioning "expense" has actually been incurred.

AVAILABILITY OF FUNDS FOR DECOMMISSIONING—THE NRC VIEW

The NRC in its regulatory role is responsible for ensuring that decommissioning is carried out so as to protect public health and safety. In developing its proposed rule on decommissioning to be released in April, the NRC has studied financial options in terms of their ability to provide assurance that adequate funds will be available for decommissioning. In its study of decommissioning financing options, the NRC strongly discourages the use of unsegregated internal reserve methods. According to the NRC's Robert Wood, "despite its apparent popularity, it is so fraught with uncertainty as to be of marginal adequacy unless coupled with insurance, or other surety arrangements, state certification, or some other mechanism to increase the assurance provided".[7] Wood found that external sinking funding provides greater assurance of the availability of funds for decommissioning at the time they are needed than does internal unsegretated funding.[8] Internal unsegregated funding provided the least assurance that funds would be available of all the methods studied by the NRC.[9] This makes obvious sense—it is the difference between having money actually set aside versus the hope that utilities will have enough borrowing power to come up with needed monies in the year decommissioning takes place.

COSTS OF EXTERNAL SINKING FUNDING VERSUS INTERNAL FUNDING METHODS

Without a tax deduction an external sinking fund is almost twice as expensive as an internal unsegregated fund. This is because unsegregated funds invested in utility assets are calculated to derive the same rate of return the company receives and because the rate base is reduced by the amount charged to the depreciation reserve.

If a tax deduction is allowed on funds held externally, however, and the internal unsegregated account remains taxable, costs of the external fund are equal to or lower than those of the internal reserve.[10] Costs of the segregated internal reserve would fall somewhere in the middle of these.[11]

Although there are many ways in which figures can be juggled to derive a desired outcome, these are the major trends which the NRC has confirmed.[12]

EQUITY OF FINANCING OPTIONS

As defined by the NRC, absolute equity to ratepayers would require that customers pay the same amount annually in constant dollars over the life of the facility.[13]

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[7] Robert S. Wood, *Assuring the Availability of Funds for Decommissioning*, NUREG-0584, Rev. 3, (Washington, D.C.: U.S. Nuclear Regulatory Commission).
[8] Ibid.
[9] Ibid.
[10] Personal communication with Robert S. Wood, February 16, 1984.
[11] Ibid.
[12] Ibid.
[13] Robert S. Wood, Assuring the Availability of Funds for Decommissioning.

The principle that ratepayers benefitting from the electricity produced by a plant should bear its costs is fundamental to electricity generation.

If cost estimates are accurate, a study of decommissioning financing options by Temple, Barker, and Sloane has found that of the four possible finance options available to utilities, external funding was the second most equitable after funding decommissioning at the time the plant becomes operable.[14] The internal unsegregated reserve was found least equitable because "its negative revenue requirements in later years constitute a subsidy of later ratepayers by near-term customers."[15] In our opinion, funding at commissioning is not the most equitable method because of the tremendous rate impact of such frontloaded funding.

ECONOMIC, HEALTH, AND SAFETY IMPLICATIONS OF INADEQUATE PROTECTION OF FUNDS—OR THE TIME VALUE OF NO MONEY

The significance of inadequate protection of funds for decommissioning has enormous ramifications in terms of financial equity to ratepayers, in terms of potential public health and safety implications, and by creating an inordinate tax burden on American consumers as a whole.

Consider the U.S. decommissioning scenario according to the NRC's and Department of Energy's (DOE) most current and optimistic figures and plans. By 2010, according to the DOE, we will have at least 70 inoperable commercial reactors.[16] This assumes reactors will have 30-year operating lives and that there will be no more premature shutdowns such as was the case with the Humboldt Bay, Indian Point 1, Dresden 1, and the Three Mile Island 2 reactors. These plants closed 17, 18, and 29 years prematurely, respectively.[17]

No permanent high-level waste repository is presently available for spent fuels. A site is not scheduled to be available until 1998.[18] With the present siting schedule slipping quickly (we are already 3 years behind), and the political complications of finding a state willing to have the site, it is easy to see the potential for extended onsite storage of spent fuels at many plants after shutdown.

Estimated occupational exposure rates for immediate dismantlement are high and are not expected to drop off until at least 30 years after plant shutdown.[19] An enormous volume of low-level waste is expected to be generated by immediate dismantlement which will not decrease sufficiently in radioactivity for offsite burial until at least 50 years after plant shutdown.[20]

These three factors make it very likely that reactor dismantlement will be delayed until 30–50 years after plant shutdown. Since the NRC does not intend to limit companies on the number of years they can delay dismantlement in its proposed rule on decommissioning, utilities will be able to wait up to 100 years to carry out this task.[21]

The question then becomes: will our existing utilities be in a position to borrow the money required to dismantle reactors in 2050?

Today's electric utility industry is in a state of transformation. At least five major companies are in severe financial condition due to nuclear cancellations.[22] It is unclear what financial condition these companies will be in in the very near future, and certainly unclear whether they will be able to float bonds at affordable rates in the future.

A strong trend has developed in the past ten years toward utility formation of holding companies which could make companies' legal responsibility for decommissioning sketchy at best. Critics of holding companies are concerned that decommis-

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[14] Temple, Barker, and Sloane, Inc., Financing Strategies for Nuclear Power Plant Decommissioning, NUREG/CR-1481 (Washington, D.C: U.S. Nuclear Regulatory Commission, June, 1980).

[15] Ibid.

[16] U.S. Committee for Energy Awareness, Press Release: "Pennsylvania Reactor Will Again Make History When Totally Dismantled Over Next Few Years," Pittsburgh, PA, Dec. 28, 1983.

[17] Sally Hindman, Duane Chapman, and Kathleen Cole, State Regulatory Policies for Privately Owned Electric Utilities in 1981, A.E. Res 82-31 (Ithaca, NY: Cornell University, October, 1982).

[18] Conrad MacKerron, "Waiting for the Waste Bill," Public Citizen's Critical Mass Energy Journal, December, 1982.

[19] R.I. Smith, G.J. Konzek, and W.E. Kennedy Jr., Technology Safety Costs of Decommissioning a Reference Pressurized Water Reactor Power Station, NUREG/CR-0130, Vol. 1 (Washington, D.C.: U.S. Nuclear Regulatory Commission, June 1978).

[20] Ibid.

[21] Personal communication with Dr. Carl Feldman, February 7, 1984.

[22] Peter Stoler, "Pulling the Nuclear Plug." Time, February 13, 1984.

sioning dollars will be used for diversification and that the utility, drained of those assets will not be able to finance decommissioning.[23]

As Robert Wood of the NRC has stated, "No matter what the current financial health of a utility is, financial solvency of any particular enterprise or even the structure of the electric utility industry cannot be projected with confidence so far in the future."[24]

In allowing utilities a tax deduction for decommissioning monies, but not requiring segregated financing mechanisms, we not only risk the possibility of a government bailout for decommissioning, but also risk creating over 130 long term high-level radioactive waste sites largely as a result of distorting the time value of money. A study by the NRC has stated that, "radioactivity will not decay to unconditional release levels within the foreseeable lifetime of any man-made structure."[25]

FEDERAL RESPONSIBILITY FOR ASSURING THE AVAILABILITY OF DECOMMISSIONING FUNDS

It would be irresponsible for the federal government to leave this funding question unanswered by allowing individual states to determine what type of funding mechanism seems most desirable to them knowing the uncertainty provided by unsegregated internal funding mechanisms that funds will be available. If a utility is financially unable to sell bonds, or even worse, bankrupt, it is likely that future ratepayers or even the federal government will be called upon to bear the costs of decommissioning. This would be unfair to future ratepayers and all taxpayers in the 15 states with no nuclear power plants.

If some states with nuclear plants adequately prepare for decommissioning by developing external sinking funds for decommissioning and others do not, citizens in those states which develop adequate funding provisions could be unfairly penalized by having to cover costs for decommissioning in states where utilities are irresponsible.

Hence, it is the Federal government's responsibility to ensure that all utilities establish funding provisions which provide real assurance that funds for decommissioning will be available at the time they are needed. This is the only fair policy for American taxpayers and ratepayers.

DECOMMISSIONING FUNDS—ANOTHER INDIRECT SUBSIDY TO UTILITIES

The clear reason for utility interest in taking a deduction for decommissioning costs is that this allows them twice the amount of capital they have access to from dollars they are collecting from decommissioning. Those utilities which are involved in captial intensive plant construction projects see dollars collected from decommissioning as an alternative source of financing compared to the rigor of establishing their worth to the investment community.

As decommissioning cost estimates increase, utilities will gain access to large amounts of contruction capital through decommissioning funds, if these monies are unsegregated and tax deductible.

Thus it comes as no surprise that in Wisconsin in 1983 Wisconsin Electric Power Co. was authorized to increase its decommissioning cost estimates 700 percent, from $3.87 million to $27.86 million.[26] Wisconsin is one of several states where utilities are attempting to diversify and form holding companies. A large quantity of cash is needed for such ventures. The tax deduction on unsegregated funds for decommissioning would make approximately an additional $14 million available to Wisconsin Electric Power Co. in 1984.[27]

As Environmental Action Foundation pointed out in Ways and Means Committee testimony in July 1983, electric utilities in 1981 alone received almost $10 billion in Federal tax subsidies.[28] These monies were made available to utilities through accelerated depreciation, the investment tax credit, shortened tax lives and other accounting practices allowed by the IRS. As Amory Lovins has pointed out, roughly 50 percent of the price of delivered electricity is taxpayer-subsidized.[29]

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[23] Peter Anderson, "The Financing of Utility Holding Companies," (Madison, WI: Wisconsin's Environmental Decade, January, 1984).

[24] Robert S. Wood, Assuring the Availability of Funds for Decommissioning.

[25] R. I. Smith, et al., *Technology, Safety and Costs of Decommissioning a Reference Pressurized Water Reactor Power Station.*

[26] Peter Anderson, "The Financing of Utility Holding Companies."

[27] Ibid.

[28] Richard E. Morgan, "Federal Tax Expenditures for Electric Utilities. Testimony before the Committee on Ways and Means," U.S. House of Representatives, July 21, 1983.

[29] Amory B. Lovins, "Note on Subsidies to U.S. Nuclear Power Systems," (Snowmass, CO: Rocky Mountain Institute, October 19, 1983).

With the U.S. federal deficit at an all-time high, expected to be at least $151 billion in 1984, it is a poor time for the government to be giving huge subsidies to any industry. It is certainly no time to increase such tax gifts in an already heavily subsidized industry. The electric utility effective tax rate is between 10 and 15 percent of net income compared to the corporate tax rate of 46 percent.

Given these already inequitable benefits to utilities it is inappropriate to add to these subsidies by allowing companies a tax deduction on funds available to them as current income. A tax deduction should only be allowed for a decommissioning finance option which will truly benefit ratepayers and taxpayers—an external sinking fund.

CONCLUSION

As the bill under consideration now stands, it makes unacceptable demands on Americans to risk banking on utility borrowing power in 2050. We believe it is in the interest of all Americans for utilities to be required to externally accrue funds for decommissioning. This is by far the safest, most equitable financing method available.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. I have no questions. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman.

I think I understand all of you, but I am not sure.

Mr. Kiefer, suppose you were sitting up here—take a hypothetical—and would you vote for my bill?

Mr. KIEFER. Given my position at the Congressional Research Service, I really shouldn't respond to that question.

Mr. GIBBONS. Answer it hypothetically. You all can answer hypotheticals.

Only 10 of us can't answer hypotheticals.

Mr. KIEFER. Economists like hypotheticals.

Mr. GIBBONS. You are not running for Congress, so you can answer that.

Mr. KIEFER. I think I would vote for your bill with some amendments.

Mr. GIBBONS. With amendments. The amendments, public power people want amendments also. What amendments do you want?

Mr. SWEETLAND. Four amendments, sir.

Mr. GIBBONS. Give them to me briefly.

Mr. SWEETLAND. We would like to have the interest earned on the decommissioning funds exempt from Federal taxes.

Mr. GIBBONS. Well, the interest that is what now?

Mr. SWEETLAND. Interest earned on the funds exempted from Federal taxes.

Mr. GIBBONS. I don't know whether we can go that far or not. Go ahead.

Mr. SWEETLAND. We would like to have the ability to establish our own funds and keep the money segregated from the company funds.

Mr. GIBBONS. You may not—why do you want to do that?

Mr. SWEETLAND. Because we want to establish our own trust fund for decommissioning purposes.

Mr. GIBBONS. You don't own—you own a piece of the plant, don't you?

Mr. SWEETLAND. In some cases, that is correct. In other cases we are unit contract customers.

Mr. GIBBONS. OK. Now, go ahead and what is the other reason?

Mr. SWEETLAND. Our third amendment would be to have any excess funds that are returned to the customers not subject to taxation.

Mr. GIBBONS. Why is that? In other words, you go along and suddenly the decommissioning costs drop because of some great technical breakthrough we haven't seen yet or maybe somebody made such a wise investment that—or something?

Why would you want the funds not taxable?

Mr. SWEETLAND. Because we would like to return them to the customers from whence they came.

Mr. GIBBONS. If they didn't pay taxes on them——

Mr. SWEETLAND. In a way it is like a loan. The customers put up the money for decommissioning. If the fund is adequate and there is money left over, it should be returned to the ratepayer.

Mr. GIBBONS. I will think about that one. Go ahead.

Mr. SWEETLAND. The fourth one would be to have the amounts authorized for decommissioning purposes to be deductible.

That is all. Just the authorized amounts.

Mr. GIBBONS. Again, what is that?

Mr. SWEETLAND. Only the amounts authorized by regulatory commissions for decommissioning purposes should be deductible.

Mr. GIBBONS. I can't argue with that one I don't guess.

Mr. SWEETLAND. OK.

Mr. GIBBONS. And the lady over here from the environmental group, you sound like you are going to vote for my bill but you had some caveats, too. What were they?

Ms. HINDMAN. I think there should be a modification in the bill which states that funds that are available to the utility to use as current income would be taxed as current income and that funds that are segregated in external reserves do have that tax deduction. So that utilities can only take a tax deduction on funds being held in external sinking funds.

Mr. GIBBONS. I guess it is a matter of what is really an external sinking fund. You certainly don't want the funds to be used by the utilities to ameliorate operating expenses or pay dividends on, of course.

Ms. HINDMAN. Right.

Mr. GIBBONS. I would assume that these funds would be under the supervision of the local rate or State ratemaking body. If we could set them up in private trusts that would probably make money for private trustees and outside counsel. We may have more regulatory problems and create more problems for ourselves if we demanded external funding.

I don't want them to commingle the funds in the operating funds for the utility business without having to account to the Federal Government and to the State local ratemaking commission.

Let me ask the gentleman from the electric utility industry, does my bill do that?

Mr. NOFTZ. It really leaves it open.

Mr. GIBBONS. To the commission?

Mr. NOFTZ. Yes, sir, the commission would decide, each State commission.

Mr. GIBBONS. Well, it leaves it open as to whether there is an external account or internal account or a separate segregated account?

Mr. NOFTZ. Yes, or there is a third, that it not be set aside specifically at all.

As Don Kiefer said, many of the utilities are in fact treating it as negative depreciation; not segregating it, but treating it as depreciation.

Mr. GIBBONS. It seems to me the wildest of possibilities is the negative salvage depreciation. Am I correct?

We may get to the year 2020—that is when you said many of the plants have to be decommissioned—and——

Ms. HINDMAN. No, not until 2040 to 2060.

Mr. GIBBONS. There may not be any money at all then if we just leave it to negative depreciation.

Mr. NOFTZ. By doing that, of course, we still are improving the financial health of the utility companies although the funds may not be set aside separately.

The companies do have the funds and would have a deduction for them and maybe not have to issue too many bonds for other reasons, and, as a result, be economically better off.

Mr. KIEFER. If I might add to that, Mr. Gibbons, the way the negative salvage value depreciation works is essentially that the company takes higher depreciation during the plant life.

Mr. GIBBONS. I see that.

Mr. KIEFER. That produces much higher charges for the future decommissioning than under a sinking fund method. Those funds are essentially brought into the company, and kept as a part of the company's capitalization. The fund in that case is really a fiction.

As the gentleman says, the company has higher internal cash flow and less need for external capital, but there is no pot of money essentially saved for decommissioning. They have to fund it later.

Mr. GIBBONS. I am that conservative kind that feels like you have to have something out there in a pot

Mr. KIEFER. Most companies do not do that presently.

Ms. HINDMAN. There are only six States using external sinking funding.

Mr. GIBBONS. But there are other varieties of where they have segregated accounts.

Ms. HINDMAN. It could be argued that moneys in segregated accounts could easily be tapped if a utility was in serious financial condition and needed those funds. There is really nothing that keeps the utility ultimately from having access to that money than if it is in a segregated internal reserve.

Mr. GIBBONS. I notice that apparently Florida, Massachusetts, New Mexico, South Dakota, and Connecticut all have funds that are segregated, but they are controlled by the public utility commissions. Am I correct in that?

Mr. NOFTZ. Yes, you are.

Mr. GIBBONS. And there apparently is, in at least half the States—I have counted on the list I have here some 24 jurisdictions—that have decommissioning funds, either external funds, in-

ternal funds, or negative salvage value depreciation. I realize they are probably not nuclear plants in all the States.

Ms. HINDMAN. There are 15 States with no nuclear powerplants.

Mr. GIBBONS. Fifteen?

Ms. HINDMAN. Fifteen with no nuclear powerplants.

Mr. KIEFER. There are varieties of funds, Mr. Gibbons. Some of the internal funds are funded, which means they are separate and invested in securities of other companies.

Mr. GIBBONS. Outside the company, yes.

Mr. KIEFER. Others are internal, but they are unfunded which means they are essentially commingled with the finances of the utility just like negative salvage depreciation value is. So it is important to distinguish with respect to the internal funds whether they are funded or unfunded.

Mr. SWEETLAND. Mr. Gibbons, that is one of the reasons why we at APPA support an amendment to establish our own fund for decommissioning purposes because of the complexities in the funding of the individual power companies.

Also, in New England, we have two single asset utilities, Maine Yankee and Vermont Yankee. Maine Yankee has its own decommissioning fund set by the State.

We would like to have the opportunity—and we have done it in the past with several municipal utilities—to set up our own funds that we would administer and have available when decommissioning takes place. We are now looking at three powerplants that will be decommissioned sometime in the year 2010, plants that were built in the early seventies.

We have about 18 years to get the funds available for that decommissioning.

Also, in working on those cases with the private utilities—Ms. Francis has been our attorney for the Massachusetts group in Boston Edison, Vermont Yankee, and Maine Yankee cases—we found for pretty much the same size plant, three widely different estimates for decommissioning purposes. That is our experience.

Mr. GIBBONS. Same kinds of plants?

Mr. SWEETLAND. Basically the same size, built around the same time, but there are big differences between the ultimate decommissioning costs.

Mr. GIBBONS. Is there any explanation for that?

Mr. SWEETLAND. The way in which it would be decommissioned.

Ms. FRANCIS. Also some corporate structures are different. Boston Edison is a company that has many assets or many different units, whereas Vermont and Maine frankly are single-asset corporations, their only asset being the nuclear powerplant.

I also would like to point out, Congressman Gibbons, that while we are looking at the right for municipals to have separate funds, there were some cities in the State of Florida which were told initially that their annual costs for meeting decommissioning would be on the order of $600,000. However, they negotiated with the company and were able to establish their own fund and, because of the more favorable tax treatment, they actually were able to reduce their costs to $200,000 annually. At the same time, they provided the appropriate level of funding to satisfy the company that they were meeting their obligation. So we think there are real sav-

ings available at least to some classes of customers if we are allowed to have our separate funds.

Mr. GIBBONS. I am exploring around a little bit.

The publicly owned utilities, what we used to call municipal plants, they are not regulated by the State utility commission, with regard to their rates, right?

Ms. FRANCIS. The regulation differs depending upon the State.

Mr. GIBBONS. Oh.

Ms. FRANCIS. In some States they are regulated by the State commission; in other States they are regulated by the city council or commissions.

So it depends which way or what structure it is and in the case of the single asset nuclear plants in Maine and Vermont, we also have a situation where their rates are regulated wholly by a Federal agency, the Federal Energy Regulatory Commission.

Mr. GIBBONS. I saw that in here, yes.

Well, generally speaking most of you at the table would vote for my bill, but some would like some amendments to it, is that right?

Ms. FRANCIS. Yes, I think it is clear that we feel the intent is strongly supported by our organization because it is of such real value to our people, but while you are at it, we think that it could be improved and we would like to see an A-1 job done on it.

Mr. GIBBONS. To tell you the truth, I am having so much trouble with Treasury I don't know whether I want to take on any more baggage.

Let's run it like it is and fight it down the road maybe. I certainly will give serious consideration to what you all have suggested here. I am sure the other members of the committee will too.

Chairman RANGEL. I think CRS had some amendments that you were prepared to offer to the Gibbons bill?

Mr. KIEFER. The study I have attached to my fuller statement does make several suggestions that we have worked with staff of the subcommittee on and would be happy to work with Mr. Gibbons on.

Chairman RANGEL. Staff would like to work on your funding proposals you had in your testimony. We look forward to continuously working with you on this matter. Thank you very much.

Mr. KIEFER. Thank you, Mr. Chairman.

Chairman RANGEL. The next panel is the American Institute of Architects, John Schlossman, former chairman of the Architectural Liability Committee; James McIntyre, counsel of the Risk and Insurance Management Society, and Ronald Stasch, corporate risk manager, Federal Mogul Corp.

Mr. Schlossman, please, from the American Institute of Architects.

STATEMENT OF JOHN I. SCHLOSSMAN, FAIA, FORMER CHAIRMAN, ARCHITECTURAL LIABILITY COMMITTEE, AMERICAN INSTITUTE OF ARCHITECTS, AND PARTNER IN LOEHL, SCHLOSSMAN & HACKL

Mr. SCHLOSSMAN. Thank you.

Mr. Chairman and members of the subcommittee, I am John Schlossman, FAIA, a principal in the firm of Loehl, Schlossman &

Hackl of Chicago, Ill. I am appearing today as the spokesman of the American Institute of Architects, the professional association representing this Nation's architects.

I have served on the institute's liability committee for a number of years including two as its chairman. I would like to enter my prepared statement in the record and briefly summarize my remarks at this time.

Chairman RANGEL. Without objection.

Mr. SCHLOSSMAN. Over the last 20 years architects and engineers have faced a liability problem of crippling proportions. In 1984 almost half this Nation's architect-engineer firms will be sued regardless of justification for an average amount of $65,000 or more.

Despite the attention received by doctors and lawyers who have a substantial liability problem, architects and engineers pay five times more for premiums and deductible expenses than any other professional group.

The ever increasing complexity of our services and the size of our projects on which we work contribute to the severity of the problem. In remarks before the Senate Subcommittee on Taxation and Debt Management in 1981, President J. Sprague DuVall of Victor O. Schinnerer & Co., the major insurer of architects and engineers, disclosed the unique nature of this problem.

He stated, the cost of investigation and defense can equal or exceed the original cost of design of a project.

Over two decades ago when the American Institute of Architects worked closely with the insurance industry to develop a professional liability policy insurance was seen as an equitable and effective way to distribute risks.

Today, however, insurance can no longer do the job alone. The unpredictability of liability has forced the insurer to use a claims-made basis, that is coverage that extends only to claims made while the policy is in force and to continually escalate premiums and deductibilities.

Of the three major insurers of architects and engineers, one has doubled and in some cases tripled its premiums this year. Others have followed suit in the past.

Architects and engineers are primarily small businesses with over 80 percent having fewer than 10 employees.

Over 90 percent of architectural engineering firms have gross revenues under $1 million and an ever-decreasing margin of profit in the unfavorable construction market of the past recession. The cost of liability is a major burden for these firms and is often second only to payroll costs. In 1981 a typical design firm with 10 employees and gross revenues of $500,000 paid $15,000 or more for $500,000 of insurance coverage with a typical deductible ranging from $5,000 to $25,000 for each claim brought.

Given the very small profit margin of such a firm, these costs are extremely burdensome.

The risk of practicing architecture is currently exceeding its potential for profit. I believe that the main reason many architects continue to practice is because of a strong personal commitment to their profession and its contribution to society.

American architects and engineering designed and built the environment in which we live. They are highly qualified technically

proficient individuals, however our profession's future is clouded by escalating liability costs and limited monetary potential.

This Nation's architects and engineers need your assistance and understanding in helping them protect their small innovative firms from financial chaos and instability. The AIA would like to offer three complimentary proposals for your consideration in alleviating this ever-growing problem of inadequate liability coverage.

A design liability trust; a 10-year carryback for professional liability losses; and a $250,000 retained income allowance for design professional service corporations.

The design liability trust will allow architects and engineers to receive a tax deduction for setting aside funds for future liability costs. This proposition will encourage designers to maintain a sufficient amount of capital to accept increasing larger deductibles and allow them to cut premium costs for higher policy limits.

The 10-year carryback is the most significant proposal because it will give small firms the financial stability they need. This proposed amendment to the Tax Code will allow architects and engineers to absorb a large liability loss over a 10-year period rather than the 3-year period currently available.

This amendment will only benefit the few firms that actually experience a catastrophic liability loss.

We expect the revenue loss from this provision to be minimal since most losses are already absorbed by the 3-year carryback. This provision will give a firm reassurance in planning for potential loss distribution and will put professional liability on an equal footing with product liability which presently enjoys a 10-year carryback.

An increase in the retained earnings allowance from $125,000 to $250,000 for a design professional service corporation will allow these companies to accumulate more capital in anticipation of future losses. This section was designed to alleviate the burden for small businesses of calculating their reasonable business needs.

This course of action would relieve many small architectural-engineering firms from the burden of justifying their anticipated professional liability losses which are impossible to calculate.

By providing design professional firms with equitable tax treatment these proposals will enable firms who have insurance to decrease premium costs or to raise their limits to cover presently uninsured liability costs.

It will also enable those who are now uninsured, a figure approaching one-quarter of all practicing architects, to qualify for the high deductibles necessary to make insurance affordable.

In both cases, this will provide architects and engineers the necessary resources from which clients and users of buildings can be compensated in the event of damage or injury.

As small businesses these firms are part of the public and their increased economic viability is essential in designing, helping provide employment and in building the capital facilities the country requires for continued economic growth.

We believe that the liability problem if left unaddressed will threaten design professionals and inhibit their ability to operate on the cutting edge of technology.

Mr. Chairman, this concludes my remarks. I will be glad to respond to any questions.

[The prepared statement follows:]

STATEMENT OF JOHN I. SCHLOSSMAN, FAIA, ON BEHALF OF THE AMERICAN INSTITUTE OF ARCHITECTS

Mr. Chairman, my name is John I. Schlossman, FAIA. I am a Principal in the Chicago architectural firm of Loebl, Schlossman, Hackl, and am appearing today as the spokesman for The American Institute of Architects.

Over the last twenty years architects and engineers have faced a liability problem of crippling proportions. In 1960 only 12 out of 100 of the nation's design professionals had a claim made against them. By 1981, the claim rate had peaked at 44 out of 100 where it has stabilized through 1983. In addition to this dramatic increase in the number of lawsuits, regardless of justification, claim severity has also increased. The typical claim in 1969 averaged $23,000. This amount climbed to $64,000 in 1981 and is continuing to rise. To understand why design professionals have been so severely affected by our society's increased propensity to litigate, one must understand the nature of the industry itself.

The liability problem experienced by architects and engineers is unique. Despite all the attention generated by doctors, lawyers and accountants, their problem is not nearly as severe as the problem of architects and engineers. Premiums paid by doctors, lawyers and accountants are only one fifth the size of those paid by design professionals.

One of the reasons architects and engineers are sued so often and for such large amounts is that the projects they work on are very complex and very expensive. As society demands larger and more complex buildings, it is not unusual to see project costs in the hundreds of millions of dollars. A project of this size and complexity which affects so many different segments of society is almost certain to generate some type of claim.

Unlike other professionals whose liability is primarily limited to their clients, design professionals are responsible to a large segment of society—including owners, lenders, insurers, subsequent purchasers, users and builders. Since so many parties are involved in the construction process and because buildings are used daily by the public, the types of claims that a designer is subject to are wide-ranging and diverse.

The architect and engineer are the leaders of the construction team. It is their responsibility to foster the advancement of building technology and create a better world for all of us to live in. As innovators, they must also carry the responsibility for their creations. Individuals truly damaged because of any problems in the design or construction of buildings deserve compensation for their injuries, and architects and engineers must share in that responsibility.

However, most A/E firms are small businesses with a limited profit potential. In 1983, roughly 80 percent of the architectural firms surveyed by the AIA had fewer than 10 employees and according to a 1977 census, 96.2 percent of the firms providing architectural services had total receipts under one million dollars and an ever-decreasing margin of profit in the unfavorable market of the past recession. Architects have always put the ideals of their profession ahead of their own economic gain and as a result their compensation is moderate in comparison with other professionals. A principal in an architectural firm will have an average salary of $39,000 and the average salaries for employees range from $13,300 for a junior technical person to $29,000 for a supervisory licensed architect.

The typical architect is not financially capable of handling a liability claim. The FAIA, in recognition of this problem, initiated a design professional insurance program in conjunction with a major insurance company over two decades ago. At that time, insurance was seen as a reliable and equitable method of sharing this risk with others.

The insurance industry has worked hard to provide architects and engineers with the insurance they need at reasonable and fair cost. However, the unprecedented escalation of liability costs, brought on by recent tort reform and a greater willingness within our society to sue anybody for anything, has made purchasing reasonable insurance a dream. Our profession became painfully aware of this during the 1970's when insurance premiums escalated and coverage was switched to a claims-made basis.

Under a claims-made policy, the insurance covers claims for errors, omissions or acts only during the term of the policy. As a result, design firms must maintain insurance long after projects have been completed and in some cases this could literally be forever—since some states do not have statutes of limitations. The insurance

companies instituted this type of policy in order to provide insurance at a reasonable rate. Unable to predict future trends, the claims-made policy allows the company to adjust its rates yearly to compensate for any fluctuations.

Of the major three insurers which sell approximately 85% of the design professionals' insurance, one has increased its premiums in the past year by doubling, and in some cases tripling, the rates. Another has experienced claim-loss ratios approaching 150% of their rates. This means that for every dollar available to pay claims, $1.50 was spent. The third major insurer has increased its claims reserve by 10% and will probably meet this increase by raising premiums. While some companies were capable of absorbing these trends in the late 1970's and early 1980's, the near future is likely to see further increases in insurance premiums.

Of even greater concern, is the unwillingness of some insurance companies to continue to provide professional liability insurance. A number of major insurers of lawyers and accountants are ready to pull out of these markets. Although we are confident that some insurance companies will stand by our industry, the loss of any insurance company will shift the risk of insuring its customers to other companies without providing them with premiums previously earned by the exiting company. This will also force the remaining companies to increase their premiums. Over the last 25 years, 14 companies have entered and left the market with only a single company providing a long-term commitment to its insureds. A stable market is necessary for proper protection when claims can be brought for as long as twenty years or more after design services have been performed.

Both the cost and long term availability of insurance presents a severe problem to our profession. In 1981 a design firm with 10 employees and gross revenues of $500,000 paid $15,000 or more—about 3% of its gross income for $500,000 of coverage. The cost of maintaining insurance has risen to the point where it is often second only to payroll costs as the greatest expense incurred by any professional. In addition to these high premiums, firms must also accept high deductibles—typically ranging from $5,000 to $25,000 for each claim that is brought. Given the very small profit margin of such a firm, these costs are very burdensome. The cost of insurance, when added to the disruption in an office and the extensive amount of time invested in defending a lawsuit, becomes a tremendous burden for the typical design firm. The liability and risk of practicing architecture is far greater than the potential profits earned. I am convinced that it is their dedication to society and their love for their profession that keep many architects and engineers practicing.

Because of the inability to make money, our profession is not growing greatly. Our economic system has traditionally allocated the cost of innovation to those who receive the benefits of such innovation. This is done by passing the cost of insurance on to the consumer who receives a better product. Today, however, insurance no longer provides a reliable method of assessing one's potential risk. I do not mean to imply by this that we do not need insurance; insurance is an integral part of the design and construction process that allows us to remain on the cutting edge of technology and progress; however, insurance can no longer do the job alone.

Our inability to assess the life-cycle cost of the liability associated with a construction project has prevented us from passing these costs on to the consumer. As a result our liability costs have been too high. As one of the largest and most technically advanced service industries in the world, architects and engineers need assistance in their efforts to stabilize and financially strengthen our profession. We request your consideration of three possible alternative revisions to the Internal Revenue Code. They are:

A design liability trust;

A ten year carry back for professional liability losses; or

A $250,000 retained earnings allowance for architectural and engineering professional services corporations.

Let me explain briefly how these three revisions to the Internal Revenue Code would work:

I. DESIGN LIABILITY TRUST

Representative Guarini and many co-sponsors introduced during the 97th Congress as HR 248, legislation that would allow architects and engineers to establish service liability trusts, in which funds could be accumulated to pay costs relating to the liability arising out of the performance of their professional services. The companion Senate bill was S. 1081. We understand and are grateful that the Congressman may plan to re-introduce this legislation in this session.

Contributions that a firm makes to the trust would be deductible as a business expense when they are made, similar to the business deductions currently available

for professional liability insurance premiums. Income earned on the funds set aside would be tax-free while it remained in the trust. When a professional liability claim arises, the trust would then provide the necessary funds to supplement the firm's professional liability insurance coverage. The amount which could be set aside in the trust would vary, depending on the severity of the liability insurance problem faced by the taxpayer.

While money paid out in insurance premiums is lost forever, money accumulated in a service liability trust will always be available to help cover claims. By allowing architects and engineers to set aside pre-tax funds in a professional liability trust, money will be available to pay the high deductibles under professional liability policies and to cover uninsured losses without serious financial disruption. The key to containing the cost of insurance is the ability to raise the deductible limits for which a firm can qualify. Because the lower levels of insurance are relatively more expensive, firms can raise the upper limits of their insurance for the same premium dollar to meet client and consumer demands for greater coverage.

If the design professional has a severe liability insurance problem (i.e., if the practitioner cannot obtain $1,000,000 of insurance coverage for less than 2% of gross earning), the firm would be able to contribute 5% of earnings up to $1,000,000 per year, into a trust, until the trust reaches a level of 15% of the firm's average gross income over the preceding five years. Other firms would be allowed to contribute 2% of earnings up to $25,000 per year, until the trust reaches a level of 10% of average gross income. A typical firm earning $500,000 per year, with a severe insurance problem could then contribute $25,000 per year into the trust until $75,000 was accumulated. Most firms would actually set aside smaller amounts.

Design professionals taking advantage of this legislation could defer some $50 million in taxes by contributing to service trusts. The impact on the Treasury is minimal, however, because much of the money that would go into a service liability trust would otherwise be paid out, year after year, in increasingly high insurance premiums that would be deductible as a business expense. All of the money placed into the trust would eventually be deductible to the firms in any event, since most claims are paid within five years of the performance of services.

Whenever funds are removed from the trust, they become immediately taxable. As with premature withdrawals from a pension fund, an additional 10% of any withdrawal will be assessed as a tax penalty where the money is not used for liability. Furthermore, if the taxpayer sells a controlling interest in the firm, the funds in the trust would become taxable. Only where the design professional completely liquidates the firm and is still subject to liability claims, such as on retirement, could the trust be maintained without a surtax. However, this does not permit the architect or engineer to "squirrel away" excess profits or to use the trust as an extra pension fund—on the contrary, it could prevent funds saved for retirement from being depleted by liability claims. Money placed in the trust could only be invested in high grade, lower yield securities such as government bonds; under no circumstances could this money be reinvested in the firm.

This legislation will benefit the public by providing design professional firms with equitable tax treatment of contributions to liability trusts. It will enable firms who have insurance to raise their limits and cover uninsured costs. It will also enable those who are presently uninsured to qualify for the high deductibles necessary to make insurance affordable). In both cases, the clients and users of buildings will have resources from which they can be compensated in the event of damage or injury. Census figures from 1977 showed the average architectural firm to consist of six persons, and engineering firms to consist of sixteen, with gross receipts of $260,000 and $608,000, respectively; as small businesses, these firms themselves are part of the public and their continued economic viability will be essential in designing and helping provide employment and in building the capital facilities the country requires for continued economic growth. Finally, because the bill directs funds into secure investments, it will contribute to the general economic recovery of the country and in particular will strengthen the economic base of government at all levels.

II. 10 YEAR CARRYBACK FOR PROFESSIONAL LIABILITY LOSSES

The AIA is proposing the introduction of legislation that would allow any professional, including architects and engineers, to carry back net operating losses resulting from professional liability over a 10-year period. Currently the tax code allows professional liability losses to be carried-back 3 years, but product liability losses are currently allowed a 10-year carryback. When a professional liability claim arises, a

professional would be able to offset the loss against past profits. Of course, only losses which were not reimbursed by insurance could be carried back.

This proposed legislation would amend Section 537 of the tax code to specifically define anticipated professional liability losses as a "reasonable need of the business." The purpose of the provision is to allow professionals the ability to carry back current losses against prior year earnings. This would be a technical amendment which would specifically state a rule which the IRS already uses in practice.

Only firms that have actually suffered a catastrophic loss would benefit from this amendment. It would only assist a firm whose losses exceed current profits and past 3-year-profits which are subject to the carryback presently available. The effect of the bill would be to protect a small business which does not have the profits to absorb large losses over a short period of time. In many cases it could mean the difference between life or death for a firm.

Although professional liability is quite different from and should not be confused with product liability, it is similar in its impact on our economy. Several years ago Congress addressed the product liability problem by providing a 10 year carryback. We believe that the professional liability problem was unjustly neglected at that time and that the tax code should be amended to provide equitable treatment between manufacturers of products and professional services. The professional liability problem is as devastating as the problem facing manufacturers and deserves equal attention.

By providing a predictable amount of tax savings, the carryback allows the professional to look at past years and assess how much risk can be handled. This will allow professionals to increase the size of their deductibles and provide more total coverage at higher policy limits. In the end, the public will benefit through the provision of greater resources to compensate injured parties and through allowing firms to carry insurance in proportion to their potential liability.

This amendment would create a loss in revenue, but we believe it will be minimal for several reasons. The legislation would only assist those who absolutely need it. In addition, most losses are already absorbed under current laws and only the unusual claim would activate the provision. The value of this amendment would lie primarily in the financial security and planning ability that it provides.

By providing design professional firms with equitable tax treatment, this bill would enable firms who have insurance to raise their limits and cover uninsured costs. It would also enable those who are presently uninsured (approaching are quarter of all practicing architects to qualify for the high deductibles necessary to make insurance affordable). In both cases, the clients and users of buildings would have resources from which they could be compensated in the event of damage or injury. As small businesses, the A/E firms themselves are part of the public and their continued economic viability will be essential in helping provide employment and in designing and building the capital facilities the country requires for continued economic growth.

III. A $250,000 RETAINED EARNING ALLOWANCE FOR DESIGN PROFESSIONAL SERVICE CORPORATION

There are currently substantial tax penalties imposed on what IRS determines to be excessive retained earnings. Current legislation allows a business to retain only sufficient earnings for the "reasonable needs of the business." The accumulation of sufficient capital for investment in major new automated equipment and for the development of contingency liability reserves requires several years. It would be helpful to raise the limit from the current $125,000 for design professional service corporations to $250,000 before the "reasonable needs" test is applied. This would simply require that artchitectural and engineering corporations be removed from the $125,000 section and classified as a general corporation which currently has a $250,000 allowance.

As stated earlier, anticipated professional liability loses are already viewed as a valid reason to accumulate capital. However, the difficulty of assessing one's potential liability makes it hard to justify anything but the most conservative estimates. Small businesses, in particular, do not have the sophistication to calculate anticipated losses. An increase in the allowance will allow firms to confidently build reserves for unforseen contingencies.

Of course, many architectural and engineering firms carry professional liability insurance to protect themselves from such claims. In nearly all cases, however, there are sizeable deductibles involved. The cost of such insurance has risen dramatically over the last ten to fifteen years. Indeed, the cost of such insurance is so substantial that an AIA membership survey in 1979 showed that forty-five percent

of architects in Texas and forty-nine percent of California architects were completely without insurance. The increasing tendency of American society to litigate, the largeness of jury awards, and the high cost of professional liability insurance points the prudent person toward setting aside liability reserves for future claims. This obviously contributes to the need for increased formation in the design professions.

[The following letter was subsequently received:]

THE AMERICAN INSTITUTE OF ARCHITECTS,
Washington, D.C., February 28, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: As President of The American Institute of Architects, the professional association representing this nation's architects, I would like to express our support for the Administration's proposal to allow an extended carryback of professional services losses in appropriate circumstances.

On February 24, 1984 Mr. John I. Schlossman, FAIA appeared before the Subcommittee on Oversight to describe the serious liability problems confronting architects and engineers. During 1983, approximately 45 out of every 100 insured architects and engineers had liability claims made against them for an average amount which exceeded $65,000.

There are many reasons for this, including the size and complexity of projects, the broad spectrum of affected parties, the position of architects and engineers as the leaders of the construction team, and the increasing tendency of Americans to litigate generally. Whatever the reasons, it is a fact that liability insurance premiums and deductible expenses for architects and engineers are some five times greater than those paid by doctors or lawyers.

An extended carryback provision in our opinion is a very good way to assist the small businesses that make up over 95% of our profession. We therefore accept and support the Administration's proposal, including the "all events" test, if an extended carryback provision of at least 10 years is allowed for architects' and engineers' professional liability losses.

The American Institute of Architects appreciates your assistance in addressing this national problem, and offers its support and assistance in carrying the solution through to enactment.

Sincerely,

GEORGE M. NOTTER, Jr., FAIA,
President.

Chairman RANGEL. Thank you.

The Chair welcomes James McIntyre, counsel for Risk & Insurance Management Society, Inc.

STATEMENT OF JAMES McINTYRE, COUNSEL, RISK & INSURANCE MANAGEMENT SOCIETY, INC. (FORMER DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET), ACCOMPANIED BY RONALD W. STASCH, CORPORATE RISK MANAGER, FEDERAL MOGUL CORP.

Mr. MCINTYRE. Thank you, Mr. Chairman.

I would like to submit my written testimony for the record and make some summary remarks.

Chairman RANGEL. Without objection.

Mr. MCINTYRE. Mr. Chairman, I am appearing on behalf of Risk & Insurance Management Society, commonly referred to as RIMS. Briefly we are a nonprofit organization representing corporate and governmental self-insurers and consumers of insurance in some 77 chapters throughout the United States and Canada.

Corporate members include about 90 percent of the top Fortune 1,000 list.

It cannot be overemphasized that the timing and measurement of tax deductions is not purely an accounting issue as implied by the Treasury in its budget briefing for 1984. But rather it is an

issue which impacts deeply on the freedom of a company to reduce costs by developing a stable self-insurance funding mechanism to deal with predictable future liabilities. To restrict a company's ability to deduct such funds and pay these predictable losses from those funds, would be to mandate inefficiency as a tax policy goal and ratify the tax inequity which already exists between the self-insured and the commercial buyers of insurance.

With respect to the accounting issue, the practice of maintaining a reserve is not only recognized but in essence mandated by the Financial Accounting Standards Board in its standard No. 5. Standard No. 5 states that reasonably predictable future payments arising from events that have occurred including self-insured losses are to be charged to income in the current period. In the *Kaiser* case the court insisted the amount of liability must be determined with reasonable accuracy before the deduction can be taken. The taxpayer used the services of an experienced loss reserve specialist to determine what amounts of funding would be required to meet its workers' compensation obligation in that year.

This accuracy was not lost on the court which noted:

> We see that the amount of liability reserved proved to be accurate within 7 percent and that to produce that modest inaccuracy Kaiser Steel underreserved rather than overreserved.

Thus in order to qualify for the deduction, the taxpayer had to prove that the amount set aside for the workers' compensation reserve reflected a sound computation and was not a number just pulled out of a hat.

RIMS must respectfully disagree with the Treasury position that the deduction allowable under *Kaiser* constitutes any kind of accounting abuse. The taxpayer in *Kaiser* actually took less deduction than it was entitled to in that particular tax year. Furthermore, the court made clear that a taxpayer could not arbitrarily reserve in a workers' compensation loss reserve fund in hopes of obtaining the tax deduction. The amount set aside in such a workers' compensation fund must be determined with reasonable accuracy before the deduction can be taken.

To arrive at such a reasonable estimate it is virtually mandatory that the services of a qualified actuary or loss reserve specialist be used by the employer in calculating its projected workers' compensation obligations in that year.

The process is in essence no different than one employed by traditional insurers in projecting their own loss reserve.

Even if no such accounting abuse occurs, some members of the subcommittee may be considering this proposal in terms of its revenue enhancement potential.

If that is the case, then RIMS must respectfully submit that those members will be greatly disappointed.

At best Treasury will get a one-shot acceleration of revenue flow as the timing of deductions is postponed to coincide with actual payment or pool of losses.

The cost to our economy on the other hand is a permanent loss of efficiency because corporations will not be able to freely choose whether to self-insure or to procure commercial insurance based on economic considerations.

Nullifying the deduction in *Kaiser* will create a situation where an employer who used a traditional insurance carrier to provide workers' compensation will receive a deduction while a self-insurer will not.

Large companies which can and now do efficiently self-insure will have a tax-motivated reason to behave inefficiently.

This result makes a mockery of Treasury's claim that revenue enhancement should be based on tax equity. What could be further from equity than to subsidize inefficient and high cost commercial insurance by disallowing deductions for all competing self-insurance funds?

Rather than further exacerbating the existing inequity toward self-insurers in the IRC, RIMS urges that this subcommittee consider reforming the tax code to permit taxpayers to self-insure certain risks in addition to workers' compensation claims, the same tax treatment with respect to self-insured reserves as if they had opted to purchase commercial insurance.

Congress, in permitting a deduction for insurance premium purchases, recognizes that protecting the entity from accidental loss is essential to sound economic planning.

Congress similarly recognized the importance of encouraging a stable funding mechanism through which claimants can receive just compensation. Yet under our present system of taxation the emphasis is placed on whether insurance is purchased or the risk transferred rather than on the quality of the funding mechanism.

A qualified self-insurance program permits corporations to lower insurance costs which would otherwise be passed on to consumers. It encourages the development of new products and services by providing an affordable mechanism to insure against certain risks.

It frees funds dedicated to that for much needed capital improvements. More important, self-insurance in combination with the purchase of traditional insurance allows the corporation to secure the broadest coverage at the least cost.

Given these facts, it makes no sense to exclude qualified self-insurance reserves as a permissible tax deduction.

As the reserves of the self-insurer and commercial insurer serve the same purpose and are subject to the same possible claims, there is no rational reason for differentiating between their tax treatment.

In determining how to implement equitable tax policy of insured and self-insured, RIMS urges the committee to consider the approach of Representative Frenzel in H.R. 2642 introduced in April of last year.

The legislation provides for a formal statutory arrangement whereby a taxpayer can comply with the *Kaiser* decision, but in addition to workers' compensation liabilities it would encompass reserves set aside for tort liabilities and fraud or defalcation cases incurred by financial institutions.

In conclusion, Mr. Chairman, a deduction taken for contributions to a self-insured reserve is not an accounting abuse, but a recognition of economically sound and socially important risk management and risk financing techniques.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES MCINTYRE, COUNSEL, RISK AND INSURANCE MANAGEMENT SOCIETY, INC.

This statement submitted for inclusion in the printed record of the Friday February 24, 1984 United States House of Representatives Subcommittee on Oversight of the Ways and Means Committee's hearing on the Timing and Measurement of Tax Deductions is submitted on behalf of the Risk and Insurance Management Society, Inc., commonly known as RIMS. RIMS is a nonprofit organization representing corporate and governmental self insurers and consumers of insurance in 77 chapters located throughout the United States and Canada. Corporate members include 90 percent of the top Fortune 1,000 list.

At this point one might ask: "What is risk management?"; "Who are risk managers?"; "Why are they so interested in the timing and measurements of tax deductions?". Starting with the last question, it cannot be overemphasized that the "timing and measurement of tax deductions" is not merely an accounting issue as implied by Secretary Regan in his February 1, 1984 Budget Briefing, but rather an issue which impacts deeply on the freedom of a corporation to reduce costs by developing a stable self-insured funding mechanism to deal with predictable future losses. To restrict the ability of the self-insured corporation to deduct funds allocated on an accurate basis to pay these predictable losses would be to mandate inefficiency as a tax-policy goal and to ratify the tax inequity which already exists between the self/insured and commercial buyers of insurance. It would be in the best interests of the Treasury, the business community and potential claimants if Congress would direct its efforts toward equalizing the tax treatment of commercial purchasers of insurance and self insureds.

The following brief explanation of the risk management process will bring this issue into sharper focus. In the not too distant past, most corporations handled their business risks by relegating the purchase of insurance to a clerk. The clerk shopped around until he or she found what was hoped to be the right coverage at the most competitive price. Occasionally, a company purchased too much or too little insurance, but, in general, the corporation was adequately protected.

Unfortunately, as business risks escalated, it became more difficult to buy insurance to cover these exposures. Premiums for standard coverages have risen astronomically, and many insurance companies simply refuse to cover high-risk operations. It has been under these circumstances of growing corporate and governmental liability exposure that the field of risk management has evolved.

Risk management is the process of planning, organizing, directing and controlling the resources and activities of an organization to cost-effectively minimize the adverse effects of accidental losses on that organization. In the last 10 years, risk management has evolved from infancy to maturity, and many top corporations now give high priority to risk management programs.

As the role of risk management and its practitioners has grown, so has the status of the risk manager; from a clerk relegated to the purchase of insurance to an expert on risk identification, risk measurement and evaluation, risk elimination or reduction, and risk finance. Obviously, not all risk can be eliminated, and it is the risk manager's task to devise the most economically efficient means to deal with an organization's risk of loss. It is this process, risk finance, which is rapidly changing the insurance industry.

Today, an increasing number of corporations are financing a major portion of their losses internally, particularly when such losses are relatively frequent and predictable. "First dollar" insurance purchases in which coverage is obtained for the full extent of the loss, is becoming rarer. A brief example explains why.

A supermarket chain might find that its loss history over a 10-year period for "slip and fall" tort liability claims is relatively consistent, approximately $500,000 a year. The corporation could purchase "first dollar" insurance coverage which would cover the corporation for the full extent of its losses. However, this approach involves an expenditure by the corporation in the form of an insurance premium which exceeds the anticipated $500,000 loss, because the premium reflects not only the anticipated $500,000 in losses it intends to pay out, but profit and overhead as well. It is in this situation that the field of risk management comes into play to determine what type and percentage of risk that should be assumed internally and, similarly, to determine the type and percentage of risk that would be more economically efficient to handle through the purchase of commercial insurance.

One such technique is to establish a reserve for expected losses. This method acknowledges the existence of risk and creates a reserve on the balance sheet. The IRS has recognized this technique in Code Section 537(b)(4), which allows the accumulation of reasonable product liability loss reserves, without subjecting the reserve

to a tax on unreasonable accumulation of earnings. It should also be emphasized that the practice of maintaining a reserve plan is not only recognized but, in essence, mandated by the Financial Accounting Standards Board (FASB) in its FASB Standard Number 5 (FASB-5). FASB-5 states that highly predictable future payments arising from events that have occurred, including self-insured losses, are to be charged to income in the current period. This directive reflects FASB's concern that predictable losses should be reflected on the corporate balance sheet.

Under present law, the reserves set aside in the aforementioned supermarket example would not be deductible. It is only under the most limited circumstances that a taxpayer can receive a deduction for reserves set aside for self-insurance. As a practical matter, the landmark case in the area, *Kaiser Steel* v. *United States of America*, 82-2USTC9635 (N.D. Cal 1982) permits the corporate taxpayer a deduction only for amounts allocated to a self-insured workers' compensation reserve. In this case, the Court stressed that all of the events that bear on the fact of liability must have occurred in the tax year in which the taxpayer is claiming the deductions. The taxpayer in *Kaiser* was able to meet this test because workers' compensation is essentially a no-fault system in which liability is attached to the employer whenever an injury occurs in the work place. Under very few circumstances other than workers' compensation, could the taxpayer claim a deduction. Moreover, the Court in *Kaiser* insisted that the amount of the liability must be determined with reasonable accuracy before the deductions could be taken. The taxpayer in *Kaiser* utilized the services of an experienced loss reserve specialist (much like an insurance company would in establishing the level of its own loss reserves) to determine what amounts would be required to meet its workers' compensation obligations in that year. This accuracy was not lost on the Court which noted . . . "We see that the amount of liability reserved proved to be accurate within 7% . . . and that to produce that modest inaccuracy Kaiser Steel under-reserved rather than over-reserved." Thus, in order to qualify for the deduction in *Kaiser*, the taxpayer had to prove that the amount set aside in the workers' compensation reserve reflected a sound computation and was not a number "pulled out of a hat".

Yet, it seems that the Administration proposes to legislatively take away the deduction permitted to the taxpayer in the legally sound *Kaiser* decision as a so-called "accounting abuse". RIMS most respectfully disagrees that the deduction allowable under *Kaiser* constitutes any kind of accounting abuse. As pointed out earlier, the taxpayer in *Kaiser* actually took less of a deduction than it was entitled to in that tax year. Furthmore, the Court made it clear that a taxpayer could not arbitrarily over-reserve in a workers' compensation loss reserve fund in hopes of obtaining a tax deduction. The amount set aside in such a workers' compensation fund must be determined with reasonable accuracy before the deduction can be taken. To arrive at such a reasonable estimate, it is virtually mandatory that the services of either a qualified actuary or loss reserve specialist be utilized by the employer in calculating its projected workers' compensation obligations in that year. That process is, in essence, no different than the one employed by traditional insurers in projecting their own loss reserves. And, as should be pointed out, amounts placed in an insurer's loss reserves are not taxable under the Internal Revenue Code.

Even if no such accounting abuse occurs, many on the Subcommittee may be considering this proposal in terms of its revenue enhancement potential. If that is indeed the case, then RIMS most respectfully submits that those members will be greatly disappointed. *Kaiser* applies to only the relatively few taxpayers who are eligible and do reserve their own workers' compensation fund. At best, the Treasury will get a one-shot acceleration of revenue flow as the timing of deductions claimed by self-insured corporations is postponed to coincide with actual payment or accrual of losses.

The cost to our economy, on the other hand, is a permanent loss of efficiency, because corporations will not be able to freely choose whether to self-insure or to procure commercial insurance based on economic considerations. Nullifying the deduction in the *Kaiser* case will create a situation where an employer who utilizes a traditional insurance carrier to provide workers' compensation coverage will receive a deduction while a self insurer will not. Many self-insured employers who desire such a tax deduction may indeed switch, either totally or partially, to a commercial insurer. Logically, it may be more costly and less efficient for the employer to obtain coverage through a commercial insurer than it would be for that same employer to self insure. The employer's deduction for obtaining workers' compensation coverage from a commercial insurer is very likely to exceed that same deduction it was permitted to deduct as a self insurer. Large companies, which can and now do efficiently self-insure, will have a tax-motivated reason to behave inefficiently. This result makes a mockery of Treasury's claim that revenue enhancement should be based on

tax equity. What could be further from equity than to subsidize inefficient and high-cost commercial insurance by disallowing deductions for all competing self-insurance funds?

Rather than further exacerbating the existing inequity towards self insurers in the Internal Revenue Code, RIMS urges this Subcommittee to consider reforming the Tax Code to permit taxpayers who elect to self insure certain types of risks in addition to workers' compensation claims, the same tax treatment with respect to self-insured reserves, as if they had opted to purchase commercial insurance.

Congress, in permitting a deduction for insurance premium purchases, recognizes that protecting an entity from accidental loss is essential to sound economic planning. Congress, similarly, recognizes the importance of encouraging a stable funding mechanism through which claimants can receive just compensation. Yet, under our present system of taxation, the emphasis is placed on whether insurance is purchased or the risk transferred, rather than on the quality of the funding mechanism.

There are many sound policy reasons for amending the Code to permit a deduction for self-insurance reserving practices. From product liability to toxic waste, Congress and the courts have been enlarging the scope of corporate responsibility in almost every area. This has not been without ramifications. The greater the liability exposure, the higher the cost of securing commercial insurance coverage, if such coverage is available at all. These higher insurance costs are passed on to the ultimate consumer of the insured corporation's products and services. Moreover, the development of new products and services can be hindered because of excessive costs of insurance coverages for new risk exposures created by technological advances. Similarly, corporate funds are being devoted to securing insurance coverage at the expense of much needed capital investment. This, in turn, has a determination impact on the competitiveness of American industry.

Given the demands of the courts and Congress, a viable mechanism for self insurance is essential to deal with these enlarged loss exposures. A qualified self-insurance program permits the corporation to lower insurance costs which would otherwise be passed on to consumers. It encourages the development of new products and services by providing an affordable mechanism to insure against certain risks. It frees funds designated for insurance purchase for much needed capital investment. Most importantly, self insurance, in combination with the purchase of traditional insurance, allows the corporation to secure the broadest coverage at the least cost. Given these facts, it makes no sense to exclude qualified self-insurance reserves as a permissible tax deduction. As the reserves of the self insurer and commercial insurer serve the same purpose and are subject to the same claim liability, there is no rational reason for differentiating their treatment for tax purposes.

RIMS is keenly aware that the Subcommittee is examining all legislative proposals with an eye towards revenue enhancement. Tax Code recognition for self-insurance reserving practices is not incompatible with this goal. That portion of the cost which the corporation will seek to deduct as self insurance would be lower than the deduction now obtained through the purchase of insurance, because neither the profit nor overhead of the insurance carrier is included. Thus, a lower deduction would be claimed by the self insurer than by this counterpart purchasing first dollar coverage. In addition, the amount saved by the self insurer is added to its tax base, providing additional potential revenue for the Treasury.

Moreover, wider use of self-insurance funding should enhance tax revenues because fewer deductible losses are incurred by the self insurer. An editorial in the trade publication Business Insurance (Nov. 22, 1982, page 8) stated, "It is quite clear from the experience in the United States that a company that pays its losses out of its own pocket in the first instance is more serious about controlling losses than the fully insured company." Companies that do self insure are aggressive about loss prevention, because the losses are felt directly on the corporate bottom line. Besides the tremendous benefit to society of fewer injuries and losses, the fiscal impact on the U.S. Treasury is clear. Fewer losses mean fewer deductions, and fewer deductions mean more tax dollars collected.

In determining how to implement an equitable tax policy for both insured and self insured, RIMS urges the Subcommittee to consider the comprehensive approach taken by Rep. Frenzel in H.R. 2642, introduced on April 20, 1983. The legislation provides for a formal statutory arrangement whereby a taxpayer can comply with the *Kaiser* decision, but, in addition to workers' compensation liabilities, it would encompass reserves set aside for tort liability claims and fraud or defalcations incurred by financial institutions.

In order to qualify for the tax deduction under H.R. 2642, the loss reserve funds must be set aside in:

(1) A self-insurance trust which would be somewhat comparable to the trust arrangement that presently exists under section 501(c)9 of the Code and is used to provide coverages for certain employee benefit programs;

(2) A standby trust support by an appropriate surety bond or letter of credit. This same approach was proposed in connection with certain environmental liability programs by the Environmental Protection Agency;

(3) Affiliated insurers which are your so-called captives. H.R. 2642 wording follows the definition for affiliated insurers found in the Federal Risk Retention Act; and

(4) Unaffiliated Insurers—These are commercial insurers which administer programs for the insured which contain substantial elements of self insurance.

The test for tax deductibility under an affiliated or unaffiliated insurer's program would be directly related to premium. Under a trust, it would be based on amounts determined in any reasonable manner that may be acceptable to the Secretary of Treasury. The bill also permits amounts to be set aside based upon determinations made by an independent and qualified actuary or loss reserve specialist. The amount set aside may also be based on an amount equal to 90% of what the taxpayer would have to pay a commercial insurer for coverage of the taxpayer's current liability for self-insured losses. This amount would be determined on the basis of a quotation from a licensed insureance carrier or brokerage firm.

There would be an annual recalculation of the liabilities covered by the trust at the end of each year to determine the adequacy of the deductions. In the event of a surplus, the excess in the reserve would be repatriated to the self insured and treated as gross income for tax purposes.

If the trust approach is used, the taxpayer's ability to terminate the trust is strictly limited. Termination is only permissible when:

(1) The taxpayer has not taken a deduction for losses self-insured through the trust in any of the five previous tax years;

(2) There are no outstanding claims of liability with respect to the risks the taxpayer self-insured through the trust;

(3) The applicable statute of limitations has run on all risks self-insured through the trust, or the risk is transferred to a licensed insurer.

These stringent termination conditions are designed to protect potential claimants by providing safeguards that the taxpayer will be around to pay loss claims when they become due.

In conclusion, RIMS urges this Subcommittee to consider the approach taken in H.R. 2642 as a responsible solution to the needs of the public, American industry and the United States Treasury. It would provide the framework in the Tax Code for the Kaiser case to be implemented with certitude, consistency, and fairness by the Internal Revenue Service. It would encourage the formation of sound financial arrangements for the payment of potential claimants. it would eliminate the dysfunctional incentive to purchase potentially more costly commercial insurance to obtain a tax deduction. This would benefit the Treasury, as a lesser deduction for insurance would be taken by the corporate taxpayer than if it would have purchased commercial insurance. It would simultaneously benefit the business community, because it would free capital used for the purchase of insurance to meet vital operating needs and capital investment requirements.

A deduction taken for contributions to a self-insurance reserve is not an accounting abuse, but a recognition of economically sound and socially important risk management and risk financing techniques.

Mr. GIBBONS [presiding]. Let me apologize here. As you know, most of us have offices both in our districts and in Washington and I had to break off and supervise an office down in Tampa with a little problem that had arisen, so I am sorry I didn't get to hear all the testimony.

Are there other members of the panel that have not been heard? You are Mr. Stasch. You go right ahead.

Mr. STASCH. Thank you, sir.

I am the corporate risk manager for Mogul Corp. in Detroit, Mich. I am here representing the Risk & Insurance Management Society and testifying for RIMS. You have our written testimony, and Mr. McIntyre has highlighted most of the major points in that prepared statement.

The only portion that probably needs a little additional comment would be H.R. 2642. This bill is a tax equity bill which would allow a business taxpayer deductions for expenses incurred in connection with certain restricted self-insurance programs.

The bill attempts to create a level playing field between the insured and self-insured business taxpayers. The bill complies with rather than violates FASB-5 and the GAAP. It requires the predictability of the expected losses with a reasonable degree of accuracy, and this can be done using the same skills and techniques presently available to the insurance industry. This was presented to the court in the *Kaiser* case, and the court felt that those facts had been met.

The bill is designed to encourage financial stability and responsibility in dealing with self-insurance as an alternative to full insurance. It encourages the proper matching of expenses to income which permits the business taxpayer to make better business decisions in the long run.

RIMS supports the concept of H.R. 2642, and we would certainly urge additional review of that bill.

Thank you.

Mr. GIBBONS. Thank you.

Mr. Schlossman, I didn't realize things had gotten that bad as far as architects were concerned. Looks like the lawyers have really been after you.

Mr. SCHLOSSMAN. Well, I believe it is due to the increasing complexity of work, the number of people that are involved in the construction process, and number of different kinds of people, and our increasingly litigious society.

Mr. GIBBONS. Are you saying that out of every 100 jobs you get, 44 of them get some kind of litigation?

Mr. SCHLOSSMAN. That is what our insurance carrier's records currently indicate, yes. That 44 out of 100 insured firms get a claim every year.

Mr. GIBBONS. Are these claims for malpractice?

Mr. SCHLOSSMAN. Well, they can be for any—from other sources, as well. They can be what is called errors of omissions; and it also can be for personal injury. And we do our best to settle as many as possible without cost, and many of the claims are settled out of court wherever possible. But the figures remain.

Mr. GIBBONS. But 44 out of every 100 jobs you undertake you get a claim arising from the project? We are not talking about somebody stumbling over a pencil in the office, are we?

Mr. SCHLOSSMAN. No, no, not in the office.

Mr. GIBBONS. We are talking about somebody outside the office?

Mr. SCHLOSSMAN. Yes; outside the office, yes.

Mr. GIBBONS. You ought to have a law firm, an engineering, and an architectural engineering firm set up together. Maybe you could go in partnership.

Mr. SCHLOSSMAN. We sometimes wonder if that wouldn't be advisable.

Mr. GIBBONS. Is there any statutory limit on the architects' services or engineers' services?

Mr. SCHLOSSMAN. Yes, there is, sir. And it varies from State to State.

Mr. GIBBONS. Roughly how long does the liability last for an architect-engineer firm?

Mr. SCHLOSSMAN. It may range in 6 years from some States—I think it is less in a few—to many more years than that in other States. I believe there are still States that do not have statute of limitations on that.

Mr. GIBBONS. I don't even think doctors get that many claims.

Mr. SCHLOSSMAN. No, I would suspect not; although I must say I don't profess to know what the case is with doctors.

Mr. GIBBONS. That is interesting. We will have to consider all these claims you all are making and see what we can do with them.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Schlossman, you indicated that the liability trust that you outlined was sponsored by Congressman Guarini. Would that be a cheaper form of insurance than is currently offered by commercial insurance companies?

And would you summarize the reasons for your views on that?

Mr. SCHLOSSMAN. The reason for that would be, it would allow architects to raise their deductibles through their own funds, and by putting away money in this trust to cover deductibles, in future years they would be able to continue raising the deductible.

The major cost in claims is at the low end of the scale, say, the first $250,000 worth of claims. By architect having such a trust fund available to meet these needs, it would reduce the amount of initial expense that it would be incumbent upon an insurance company to pay.

Mr. DUNCAN. Would you comment on the actual insurance value your proposal offers as a guarantee to future claimants; that is, that the money will be available to settle their claims the same as with commercial insurance?

Mr. SCHLOSSMAN. I would prefer to give you an answer to that, sir, in writing and we will be pleased to do so in a few days.

[The information follows:]

THE AMERICAN INSTITUTE OF ARCHITECTS,
Washington, D.C., March 15, 1984.

Hon. JOHN J. DUNCAN,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE DUNCAN: In reply to your question to Mr. Schlossman, during the hearing of the Ways and Means Subcomittee on Oversight on February 24, 1984 the Design Liability Trust Legislation sponsored by Congressman Guarini would insure that the money set-aside would be available to future claimants through the imposition of a ten percent penalty on any funds not used for liability losses. In addition, the trust would not be mingled with other assets of the firm.

It should be noted that the trust is not intended to replace insurance, but only to suppplement it.

Sincerely,

JOSEPH S. CRANE,
Administrator, Government Affairs.

Mr. DUNCAN. If the purpose is to provide for inexpensive insurance to architects, have you thought about the industry getting together and forming an insurance company?

Mr. SCHLOSSMAN. So-called captive insurance company, yes, we have thought about that.

The ramifications of doing that are many.

There are strong arguments for it, but ultimately one wonders whether we are architects or should be in the insurance business.

Mr. DUNCAN. Treasury's proposal is that a deduction will be available only when the settlement amount is paid. Would that be acceptable to your organization if it was coupled with an unlimited loss carryback provision?

The Treasury proposed that the deduction will be available only when the settlement amount is paid.

I asked if it would be acceptable if it was coupled with an unlimited loss carryback provision?

Mr. SCHLOSSMAN. Yes, that would be acceptable.

Mr. GIBBONS [presiding]. I thought this problem sounded familiar. I ran into it one time a number of years ago with the lawyers in Florida, and the lawyers title guarantee fund, and somehow they were able to work out their problem with the Treasury.

Maybe if you all would look at the way the lawyers in Florida, through the lawyers title guarantee fund doubled their problem. Their headquarters are in Orlando. A lawyer by the name of Fletcher Rush who did most of the work on the thing may be able to help you find some way to puzzle it out.

They had a problem very similar to what the architects have got, and they worked it out somehow. The fund is still in operation.

Mr. SCHLOSSMAN. I have noted that, sir.

Mr. GIBBONS. Maybe it was not exactly like yours. I am speaking from a rather stretched memory right now, but I remember Mr. Rush contacting me. I got him in touch with the proper people in the Treasury and finally, they worked it out. I am sure they got some kind of ruling on their proposal. I don't know whether Treasury indexes those plans or whether they will know what they have ruled in the case or not. It was a very complicated problem and it affected many of the lawyers in Florida. It was a very similar problem. They would be called on to guarantee titles of land that they had examined.

They worked out their differences somehow.

Mr. SCHLOSSMAN. Our insurance advisors may be familiar with Mr. Rush and I have noted his name here.

Mr. GIBBONS Maybe he can help you or tell you who to talk to, and maybe you could then refresh the Treasury's recollection as to what they did in that case.

If they have not changed their policy, maybe they can work it out for you again.

There are human beings down there in the Treasury, so they may not happen to remember these things. I do not think they have any indexing system to help them find earlier cases. Maybe you could try to solve some of your problems by talking with Treasury.

Mr. McIntyre, glad to see you back here. Things have gotten a lot worse since you left. Maybe you can come back and help us out again some time.

Mr. MCINTYRE. You almost convinced me to vote for your bill.

Mr. GIBBONS. Thank you all very much for coming here.

We are down to our last panel: Kaiser Steel Corp., Consolidated Freightways, Hospital Corporation of America, and Mutual Protection Trust.

STATEMENT OF PAUL H. DAWES, COUNSEL, KAISER STEEL CORP.

Mr. DAWES. My name is Paul H. Dawes, partner at the law firm of Thelen, Marrin, Johnson and Bridges located in San Francisco. I am appearing here this afternoon on behalf of Kaiser Steel Corp., which is a publicly held company having its principal place of business in California. Until recently, it manufactured steel and presently is engaged in the fabrication of heavy steel products. I am here to speak on the administration's proposal concerning so-called premature accruals.

That is a topic that I have become somewhat familiar with in connection with a lawsuit called *Kaiser Steel Corp.* v. *United States of America* which was tried in the Northern District of California last year and recently affirmed by the Court of Appeals for the Ninth Circuit.

We are here to oppose the adoption of a so-called premature accrual provision insofar as it bears upon the deduction of accruals for workers compensation expenses.

I would like to briefly indicate that Kaiser Steel, as a California employer, is subject to the Worker Compensation Act of the State of California. Kaiser Steel provides benefits to employees arising out of injuries incurred in the course of its employment.

Now, these benefits are not quantified in the somewhat unpredictable sense that typical tort injuries are priced.

These benefits are specified, and they are payable, according to specific statutory formulas.

These formulas specify maximum and minimum ranges. There is an entire industry of professionals which have medical, statistical, and information management skills that are necessary to determine the expense that is involved in an industrial accident.

Kaiser Steel is a self-insured employer as to worker compensation expense, at least to a significant portion, and of course, it is an accrual basis taxpayer.

The recent victory of Kaiser Steel in the court of appeals established that existing liabilities for worker compensation benefits that are payable in the future regarding uncontested cases satisfies both prongs of the so-called all events test.

Therefore, the court held that as an accrual basis taxpayer, Kaiser's reserve was deductible in the year that injuries actually occurred, not in the year in which benefits were paid to the injured employees.

The administration's proposal seems to be premised upon concerns relating to the time value of money and the potential abuse of permitting deductions where liabilities have not been incurred or may not be paid for many, many years.

These concerns may be legitimate in certain contexts, particularly where the deduction sought does not achieve the overriding tax objective of using a system of accounting which clearly reflects the taxpayer's true income.

The problem that I perceive with the administration's proposal is that it amounts to a sweeping and fundamental change in the nature of accounting principles and results in a distortion rather than the clear reflection of income. To the extent that it is proposed for the purpose of generating additional tax revenues, I doubt that that is going to occur, and in fact, it may very well not.

The reasons for my skepticism about the proposal are four-fold.

First, the concept of the taxation of net income on an annual basis would be altered under the proposal that the administration makes, and that is because the proposal rejects the notion of using the system of accounting which clearly reflects income, and thereafter taxing that income.

Second of all, I believe that the proposal reflects a misunderstanding of the role of the all events test in clearly reflecting income. Under the all events test, contingent and contested liabilities are not deductible.

That is so even though they should be included under generally accepted accounting principles, and my point is that the first prong of the all events test functions already to deny deductions wherein the taxpayer is not yet subject to a present liability.

Third, the administration's concern about the time value of money, and abuses in the tax shelter area are minimal at best, as it regards worker compensation deduction.

The ninth circuit allowed Kaiser Steel to take the deduction because it was not premature. As a matter of fact, Judge Merrill, who wrote the panel's decision, indicated that once the liability was fixed and the taxpayer could determine the amount of liability with reasonable accuracy, the taxpayer didn't even have a choice. Under the code, it was required to take the deduction in the year in which the industrial accidents had occurred.

Permitting the deduction in advance of actual payment simply is not going to provide manufacturing entities like Kaiser with tax shelter advantages.

The purpose of this deduction is not to enable it to show a loss in a start-up year in the same vein that limited partnerships may be used for investment purposes, and the whole system of worker compensation has so many checks and balances that are built into the system that one simply can't choose to take a deduction arbitrarily in order to thereby minimize tax exposure. The employer doesn't cause an injury or impose the tax liability to pay the worker's compensation expense.

It is on the State's books; and when the injury occurs, the obligation to pay that liability is there, and therefore, the opportunity for discretion is simply not available to the taxpayer.

Moreover, I should point out as to the concern about the time value of money, I learned through the prosecution of the Kaiser Steel case, specifically through the expert testimony of a Mr. Ed Struck who formerly was the manager of Self-Insurance Plans for the State of California, that in the worker compensation area, there is a test, 30–30–15 test which is used to determine when payouts will actually occur on a particular injury that has occurred in a specific year, and the test simply says that within the first year of an industrial accident as statistics go, 30 percent of the total expense incurred in that particular liability will in fact be paid out

during that first year and 30 percent the second year and 15 percent the third year and the marginal amount will be paid thereafter, so we are not dealing with a situation in which there is a very lengthy or unpredictable period of payment of expense.

Last, I believe that the adoption of the proposed rule will result in confusion, and additional expense and may not generate additional revenue.

The all events test has worked for 60 years. The language which is proposed by the administration is quite confusing and undoubtedly is going to result in additional litigation. The administrative burden on corporations in employing this new system of taxation, accounting that is, is going to be considerable.

Last, if self-insurers are not permitted to take this deduction which the ninth circuit has sanctioned, in this area, they are going to buy worker compensation insurance and by buying insurance, they are going to be permitted to take the deduction and the consequence of that is going to be that the administration will not enjoy additional revenue through this proposal.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL H. DAWES, COUNSEL, KAISER STEEL CORP.

Mr. Chairman and members of the Subcommittee on Oversight, House Ways and Means Committee, my name is Paul Dawes and I am a member of the law firm of Thelen, Marrin, Johnson & Bridges. I am appearing today on behalf of our client, Kaiser Steel Corporation.

Kaiser Steel Corporation is a publicly held corporation with its principal place of business in California. Kaiser Steel, directly and through its subsidiaries, sells steel and steel products, engages in heavy steel fabrication and erection activities, and mines and markets metallurgical and steam coal. Until recently, Kaiser Steel was also engaged in the business of the manufacture and fabrication of steel and steel related products at various facilities including its Southern California facilities at Fontana.

As such, Kaiser Steel is subject to the provisions of the Workers' Compensation Act of California, as set forth in the California Labor Code, which requires Kaiser Steel to provide workers' compensation benefits to its employees (or their dependents in the event of death) with respect to all injuries arising out of and in the course of employment, without regard to negligence, subject only to limited statutory exceptions. These benefits, which are determined and payable according to statutorily specified standards and formulas, in ranges of minimum and maximum amounts, include: (i) the provision of necessary medical treatment and/or reimbursement for the costs of such treatment; (ii) temporary and permanent disability payments; and (iii) death awards. The benefits required by the California law are provided by Kaiser Steel under a program of self/insurance which it began in 1964.

Although its program of self-insurance began nearly twenty years ago, Kaiser Steel has just recently won an important victory in the U.S. Court of Appeals for the Ninth Circuit establishing the proper taxable year for deduction of its workers' compensation liability.[1] In the *Kaiser Steel* case, the Ninth Circuit held that Kaiser Steel's liability as a self/insured employer for workers' compensation benefits payable in the future with respect to the uncontested claims of employees injured during the taxable year satisfied the two prongs of the "all events" test. In accordance with the accrual method of accounting used by Kaiser Steel, the Ninth Circuit therefore held that Kaiser Steel's reserve for such liability was properly deductible for tax purposes in the year in which its employees were injured, rather than in the year in which the benefits were actually paid to the employees as contended by the government.

The allowance of the deduction in cases such as *Kaiser Steel* for workers' compensation or similar liabilities prior to the taxable year in which the taxpayer actually pays the expense appears to be of particular concern to the Administration. Specifi-

[1] *Kaiser Steel Corp.* v. *United States*, 717 F.2d 1304 (9th Cir. 1983).

cally, the Administration's revenue proposal dealing with "premature accruals" being considered today would change the "all events" test to provide that no deduction would be allowed until "economic performance occurs," i.e., until the taxpayer has a "current obligation to satisfy the liability." The only proposed exceptions to this rule relate to cases in which economic performance will occur within one year after the close of the taxpayer's taxable year or in which other sections of the Internal Revenue Code apply, such as section 166 relating to the deduction allowable for bad debts. Thus, for example, the summary prepared by the Joint Committee on Taxation Staff states that under this proposal no deduction would be allowed in the case of workers' compensation until the liability is satisfied.

The Administration's proposed change in the "all events" test and, in effect, in the results reached by the courts in cases such as *Kaiser Steel,* is premised upon concerns relating to the time value of money and the potential abuse perceived in permitting taxpayers to currently deduct the full amount of liabilities incurred during the taxable year, where such liabilities may not be paid or payable for many years. Certainly these concerns may be legitimate and may merit some limitation on the deduction available in circumstances in which the taxpayer has intentionally structured a transaction to take advantage of the tax shelter afforded by the current deduction of liabilities payable only in the distant future. Indeed, the courts themselves have on occasion limited the deduction allowable in such circumstances of potential abuse where the deduction sought would not achieve the overriding tax objective of clearly reflecting the taxpayer's true income.[2]

It is not my intention today to defend the "all events" test in circumstances which may involve true abuse of the acrrual method of accounting. However, the difficulty I have with the Administration's proposal is the sweeping and fundamental nature of the change proposed. In particular, I believe that the proposed alteration of the "all events" test governing the proper year for deduction of expenses would produce a distortion in our system of taxation far worse than the evil it is intended to cure for the following four reasons.

(1) The proposed limitation on the deduction of all liabilities incurred during the taxable year, other than those payable within one year, is inconsistent with the underlying purpose of the accrual method of accounting.

Since the Revenue Act of 1916, taxpayers who use the accrual method of accounting for financial purposes have been permitted to use that method in computing their taxable income. As discussed by the United States Supreme Court in *United States* v. *Anderson,*[3] the case wherein the "all events" test originated, the underlying purpose in permitting taxpayers to compute their tax liability pursuant to the accrual method of accounting is:

" . . . to enable taxpayers to keep their books and make their returns according to scientific accounting principles, *by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;* and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis." 269 U.S. at 440 (Emphasis added.)

Consistent with this purpose, the hallmark of the accrual method of accounting is the ability of the taxpayer to properly match against the income earned during the taxable year the expenses incurred in and properly attributable to the process of earning that income, without regard to either actual cash receipts or disbursements. This matching, and the clear reflection of income which results therefrom, has been historically achieved under the parallel "All events" tests which govern the proper year the recognition of income and deductions. Thus, while taxpayers using the accrual method of accounting are required to report their income in the taxable year in which earned, i.e., the year in which events have occurred which fix their right to the income and the amount thereof can be estimated with reasonable accuracy, they are likewise entitled to offset such income by those expenses definitely incurred in the taxable year i.e., those expenses as to which all events have occurred which fix the fact of liability and the amount thereof can be determined with reasonable accuracy.

The proposed amendment of the "all events" test governing deductions, but not the rule governing recognition of income, would seriously undermine the basic purpose of the accrual method of accounting. In effect, by placing the deduction of expenses on a modified cash basis, the matching concept which is central to the clear reflection of income under the accrual method of accounting, and indeed fundamen-

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[2] See, e.g., *Mooney Aircraft, Inc.* v. *United States,* 420 F.2d 400 (5th Cir. 1969).
[3] 269 U.S. 422, 46 S.Ct. 131 (1925).

tal to the principal goal of our entire system of taxation of net income on an annual basis, would be lost.

(2) The proposed change of the "all events" test reflects a basic misunderstanding of the role of that test in assuring the clear reflection of the taxpayer's income on an annual basis.

The "all events" test was itself developed by the Supreme Court in the *Anderson* case for the purpose of distinguishing those liabilities which are definitely incurred in and properly attributable to the process of earning income during the taxable year, and hence deductible, from other liabilities which may be properly accrued on the taxpayer's books for financial accounting purposes but which are not in fact definitely incurred during the taxable year. For example, it is well settled under this rule that no deduction is allowable for future, contingent and contested liabilities until all events have occurred which render the taxpayer subject to a present and existing liability.[4]

The ostensible purpose of the proposed amendment to the "all events" test is "to restrict the current accrual of future liablities." However, the necessity which already exists under the first prong of the "all events" test for an existing, fixed and certain liability serves to prevent most instances of potential abuse in which taxpayer seek a deduction prior to the time there is an actual liability.[5] Thus, the impact of this proposal would not be felt in those cases in which the taxpayer is not yet subject to a present liability, since such liabilities may not now be deducted under the existing law.

Instead, the impact would be felt only in those cases, such as the workers' compensation liability involved in *Kaiser Steel*, in which the taxpayer's liability has been found to be definitely incurred in and properly attributable to the process of earning income during the taxable year, but the liability is not actually payable within one year after the close of the taxable year. In effect, by focusing solely on a mechanical one-year payment rule, the proposed amendment loses sight of the nature of the liabilities involved and whether or not deduction of such liabilities really represents an accounting or tax abuse.

(3) The statutory disallowance as "premature accruals" of expense items such as workers' compensation liability would result in a distortion of the taxpayer's true income in circumstances in which the Administration's legitimate concerns relating to the time value of money and potential abuse are minimal at best.

Kaiser Steel was allowed the deduction for its workers' compensation liability by the Ninth Circuit for precisely the reason that the Court determined that the deduction thereof was not "premature" for tax purposes.

Specifically, the Ninth Circuit held that under California's workers' compensation law once a workers' injury has occurred in the course of employment and liability is not contested by the employer, all events have occurred determining the fact of liability and the first prong of the "all events" test has been met. In addition, based upon the detailed findings of the trial judge relating to Kaiser Steel's reserving and accounting practices, and the accuracy in the aggregate of its reserve for benefits payable to the injured employees in the future, the Ninth Circuit found that Kaiser Steel had determined the amount of its statutorily imposed liability with reasonable accuracy and the second prong of the "all events" test had been met. In sum, the Ninth Circuit agreed with the trial court's finding that:

"Kaiser Steel's system for reserving for its workers' compensation liability was in accordance with applicable law, was commercially reasonable, was logical and scientific, and was well suited for its purpose of accurately reflecting the worker's compensation liability which KAISER STEEL incurred in the process of generating income in 1964." 717 F.2d at 1309.

Thus, it was not only upon the Court's determination that Kaiser Steel's liability satisfied the "all events" test but also upon its determination that the accrual thereof clearly reflected Kaiser Steel's income for the taxable year in issue that deduction was permitted in the year the employees were injured and the statutory obligation incurred, rather than in the subsequent years in which the benefits were actually paid.

Permitting the deduction in advance of actual payment did not offer Kaiser Steel a significant tax shelter potential. The nature of the workers' compensation liability

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[4] E.g.: *Lucas* v. *American Code Co.*, 280 U.S. 445, 50 S.Ct. 202 (1930); and *Brown* v. *Helvering*, 291 U.S. 193, 54 S.Ct. 356 (1934). *See also, Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 99 S.Ct. 773 (1979).

[5] See, e.g., *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786 (1974) *aff'd* 564 F.2d 886 (9th Cir. 1977); *Trinity Construction Co.* v. *United States*, 424 F.2d 302 (5th Cir. 1970); and *Clevite Corp.* v. *United States*, 386 F.2d 841 (Ct.Cls. 1967).

is such that Kaiser Steel neither could not did delay satisfaction of its statutory obligation to the injured employees for many years beyond the close of the taxable year in issue. In fact, as the government in the *Kaiser Steel* case stipulated and argued, on a numerical basis, in most of the cases of employee claims included in Kaiser Steel's reserve, the required workers' compensation benefits were paid and all liability satisfied within two or three years of the injury. In certain cases Kaiser Steel's liability for payment of the required benefits did extend over a period of as much as five years. However, only in rare cases, representing a small fraction of the total reserve, did it extend for periods longer than five years.

The fact that Kaiser Steel's workers' compensation liability was for the most part actually satisfied within two or three years of the injury is not surprising. As testified to at trial in the *Kaiser Steel* case by Mr. Ed Struck, who served as the Manager of Self-Insurance Plans for the State of California from 1964 to 1977, the industry experience demonstrates a phenomenon in the workers' compensation area that workers' compensation cases in the aggregate are paid off on the basis of thirty percent in the first year (i.e., the year of injury), thirty percent in the second year, fifteen percent in the third year, and the balance over a number of years. Thus, the industry averages demonstrate that in most cases, as in Kaiser Steel's case, approximately sixty percent of a self-insured employer's liability will actually be paid within twelve months of the close of the taxable year in which the injuries occur and the statutory liability is imposed, i.e., within the payment period for which the Administration's proposal itself contains an exception permitting deduction.

In addition to the fact that, as a practical matter, the bulk of the workers' compensation liability of a self-insured employer does not represent a liability that will be satisfied only many years in the future, it is important to recognize that the nature of the workers' compensation liability is such as to provide no room for intentional deferral or accounting abuse. As already mentioned, the time and amount of the benefit payments required of the employer are statutorily prescribed. Thus, the situation involving workers' compensation liability is readily distinguishable from circumstances in which the taxpayer might attempt to contractually incur a liability payable only in the distant future and thereby gain a current deduction providing an immediate tax benefit in excess of the discounted present value of the deferred liability.

In short, it does not appear that the concerns relating to the time value of money and potential taxpayer abuse justify the distortion of true income which would result from disallowing an employer's liability for workers' compensation benefits. The income of an accrual basis taxpayer, such as Kaiser Steel, arises out of the services of its employees. It must accrue and report that income as earned, whether or not actually received. The most logical correlation of income to expenses is to deduct in the year injuries are sustained in the process of generating such income the liability incurred by the employer for workers' compensation benefits payable to the injured employees.

(4) Adoption of a test which depends upon when "economic performance occurs" or the taxpayer is subject to "a current obligation to satisfy the liability" would engender substantial uncertainty and confusion at the expense of the overriding tax objective of clearly reflecting income which exists under the established "all events" test.

As indicated previously, the "all events" test has been an integral part of the accrual method of accounting for nearly sixty years. It was adopted by the Supreme Court in the *Anderson* case to provide a mechanism for determining the true income of the taxpayer by properly matching the liabilities definitely incurred and properly attributable to the process of earning income during the taxable year against that income, and it has worked well for its intended purpose.

The change now proposed would substitute for the existing test one based upon when "economic performance occurs" or the taxpayer is subject to "a current obligation to satisfy the liability." Such phrases raise the question of what is meant thereby and how to distinguish "a current obligation to satisfy the liability" from the present standard expressed by the first prong of the "all events" test which already requires a fixed and certain liability. If the proposed phrases are meant to exclude from deduction all liabilities except those actually paid within the taxable year, or within twelve months thereafter, they nonetheless create uncertainty as to the deductibility of expenses, such as the workers' compensation liability, where a substantial portion but not all of the liability will actually be paid within the allowable period.

Moreover, regardless of the exact wording of any statutory amendment which might be adopted under the Administration's proposal and the interpretation ultimately given thereto, it seems apparent that the objective of clearly reflecting

income would be sacrificed, since the talisman would be the obligation to pay or actual payment without regard to the year in which the liability itself is incurred or the income to which it is properly attributable. Such a fundamental change in our basic system of taxation should not be adopted lightly nor merely for the expedient of reducing the federal budget deficit at the expense of accrual basis taxpayers.

CONCLUSION

For all of the above reasons, I believe that, in addressing the Administration's concerns relating to the time value of money and potential abuses under the accrual method of accounting, the proper approach is to focus on specific instances affording the opportunity for true abuse and manipulation, as, for example, the Administration's proposal dealing with related party transactions does. Such a focused approach, in contrast to the sweeping and fundamental change proposed with respect to the "all events" test, would provide a means of curbing tax shelter and abusive transactions without jeopardizing the legitimate deduction of liabilities, such as the workers' compensation liability, incurred by accrual basis taxpayers.

Thank you for this opportunity to present this view on behalf of Kaiser Steel Corporation of the Administration's proposal dealing with "premature accruals."

Mr. GIBBONS. Our next witnesses are Mr. Merritt and Mr. Young.

STATEMENT OF JAMES E. MERRITT, COUNSEL, CONSOLIDATED FREIGHTWAYS, INC., ACCOMPANIED BY HOWARD A. YOUNG, DIRECTOR OF TAXES

Mr. MERRITT. I am James E. Merritt.

I am a tax attorney and I am appearing with Mr. Howard A. Young from Consolidated Freightways. I have a great deal of experience with the taxation of workers compensation, and Mr. Young has had a great deal of experience in the administration of those claims.

We are here because we believe that workers compensation has been improperly caught up in the Treasury's proposals which are geared to do some rough justice to tax shelters and tax abuse situations. Workers compensation is neither a tax shelter nor a tax abuse situation.

Let me first say that we have submitted detailed and substantial written materials which we would like to have made part of the record.

Mr. GIBBONS. Yes. It will be included.

Mr. MERRITT. I would like to focus on some of the things that have been said this morning and summarize the major points of our presentation.

Let's examine what are indeed the Treasury's proposals. They are to require someone incurring a worker's compensation liability to take a deduction for that liability only when a payment is made which extinguishes the liability to the claimant, that is, a disguised way of saying to put you on the cash method.

Some things that have been said are true. It is true that if you get to use money for a period of time there is a benefit, that is the time value of money concept. It is also true that if the Treasury Department can require persons to report income when it is accrued but to deny deductions they may bring in some revenues for a short period of time. The other truth that hasn't been mentioned that much is that this proposal really does violence to the matching of income and expense. Mr. Sunley said from the economic point of view, liabilities for workers compensation should be matched with the income in the year of the injury and the account-

ing profession said the same thing and three circuit courts of appeals have said the same thing. The rationale for the *Kaiser* decision, and the two prior decisions, was that a proper matching of income and expense requires and supports the deduction of workers compensation liabilities in the year the injury occurred.

The other thing that is not being told to you about the proposal, and I am a little surprised, because what is in fact the truth is that it is more restrictive than the current position of the IRS. For example, there is a revenue ruling, published in 1969, which really simply republished a prior income tax ruling from back in the thirties that says, you must deduct an award for worker's compensation liability in the year the award is entered. That may be an award requiring the employer to make payments for 20 years, but the full face amount is deductible in the year it is awarded.

It is also not pointed out that at the current time, the IRS says as medical expenses are performed, you can accrue those expenses. The Treasury's proposal says no, you cannot accrue them at that time.

It was also not pointed out that Congress has enacted code section 461(f) that provides a taxpayer gets a deduction when they make a payment to a trust beyond their control. Payments into that kind of trust would not be deductible under the proposal.

I think, frankly, Mr. Chairman, the problem is the Treasury Department has really not understood what is involved with worker's compensation. Mr. Dawes gave you some description of it. We are not talking about the hypothetical everybody uses which is that we have an accrual today of $1 million and we pay $1 million 10 years in the future, and nothing happens in between except that you earn interest. That is not our case. The injury occurs today, the taxpayer starts an accrual today and starts paying medical expenses tomorrow. Almost all of your temporary disability claims are going to be paid and resolved within approximately 6 weeks. It is true that those that extend beyond that period of time may take up to a year or two to be resolved.

There are, however, two types of worker's compensation liabilities that do extend over a period of time. These are when you have a death benefit where you make payments to the widow and surviving children, and those involving benefits to permanently disabled employee. In both cases, payments may continue until the children reach maturity or the widow or disabled employee dies.

Under current law, we cannot and do not deduct any payments to the widow in the future, because that is subject usually to a contingency that the payments terminate upon remarriage. There is, however, in most States a provision that even when she remarries, you make payments for 2 years. We do accrue that two-year payment.

I think what Mr. Pearlman has done is confused and associated with worker's compensation liabilities with structured settlements. That is wrong. A structured settlement, as is classically described, is when somebody has the option to make a payment now, and they use big numbers like $1 million today, but I will talk you out of taking $1 million today, instead I will pay you $3 million 15 years from now, and I accrue the $3 million today and the deduction

gives me so much money as I invest it and earn income on it that I will have more than $3 million when I have to pay you off.

That is not what happens in worker's compensation. The amount of payments are being paid weekly and monthly and are prescribed by State statute. You cannot make a lump sum payment without the permission of the State. Worker's compensation is not intended to give somebody a windfall right now. It is intended to make sure that they have a certain amount of money coming to them on a weekly or monthly basis for the rest of their life.

The other thing that is missing in what has been presented is that frequently, workmen's compensation payments must be made to the State. Their proposal would even disallow that and that happens in some States where on certain types of large injuries, the State requires the taxpayer to make a payment to it. The payment goes to the State and the State makes the payment to the disabled employee. A taxpayer could not deduct that amount when it paid it to the State because the liabilities to the claimant have not been extinguished until the State subsequently makes those payments, under the proposal.

The *Kaiser Steel* case. This is at the heart of the problem, Treasury disagrees with the courts. Under the all-events test, one, something has to happen that determines the fact of liability. The Treasury Department says that is not the injury. That is when somebody is not at work because they are disabled or when the doctor renders the medical services. The Ninth Circuit Court of Appeals has looked at this, going back to 1975, and they have looked at workmen's compensation law and said a proper analysis of that law is that the liability is fixed at the time of the injury. The only thing that is left in doubt is how much your liability will be. On the requirement of reasonable accuracy, we have given a detailed explanation of that. The amounts that we are accruing are determined with reasonable accuracy.

Another point that was not made is that there are adequate safeguards under the current law. Mr. Pearlman asked as to the status of the *Kaiser Steel* case, and I can answer that. The Government decided not to seek review by the U.S. Supreme Court. They might well have done that. I instead they decided, not to. You could decide that they should have done that first before coming here.

There is a *Mooney Aircraft* case saying that as to payments so far down in the future, 20 years for example, you can disallow deductions for those future payments.

There is a *Goldstein* case which says if a taxpayer says, "I will pay you more than I really owe you because I am going to get a tax deduction for it," you can disallow that extra deduction as not being an ordinary and necessary expense and that should be used some by the Govenment before they come here and seek to do rough justice.

I know I am going on a little bit long, but I have a few more points. We have talked about some specific areas, but the Treasury's proposal is to disallow all accruals. You go away from the all-events test and go to an "economic performance" test. They define economic performance for the specific areas we have talked about, but not for anything else. What will it be for taxes, payroll taxes, supplies? Are they going to come up with rules to tell you some-

thing different than the all-events test? I don't think you should enact the "economic performance" test for that reason alone.

You heard a lot of talk about expansion of net operating loss provisions giving plenty of relief for taxpayers. I think that also you should consider what proper transition rules should be adopted. The date of enactment is a really unfair rule. It would be much better to have it at the end of the taxable year in the year of enactment and in the next year, you start applying a new concept. Nobody will take advantage of a future effective date for this kind of provision. People won't go out and get injured in order to get more deductions this year, and the effective date should be determined with regard to injuries occurring after some point in time. The injury is what determines the accrual. It should be that instead of transactions.

One of the other things they did is deny taxpayers the relief that you would get if they changed you from accrual to a cash accounting method. If you do that and you go in under the revenue procedure which the IRS would apply, if a change were made, you would get a 10-year spread of the adjustment. Treasury is trying to avoid that rule.

We will be very happy to answer any of your questions.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES E. MERRITT, COUNSEL, AND HOWARD A. YOUNG, DIRECTOR OF TAXES, CONSOLIDATED FREIGHTWAYS, INC.

Mr. Chairman and members of the subcommittee, we appreciate the opportunity to appear before the Subcommittee on behalf of Consolidated Freightways, Inc. I am James E. Merritt, a partner in the Washington, D.C. office of the law firm of Morrison & Foerster. I accompany Mr. Howard A. Young, Director of Taxes for Consolidated Freightways, Inc. We will present the most important points set forth in our written comments, copies of which we have previously furnished to the staff, and we request that our written comments be included in the record of these hearings.

Consolidated Freightways, Inc. is one of the largest motor common carriers and air freight forwarders in the United States. It employs approximately 18,000 persons and operates in all 50 states, the District of Columbia and Canada.

Consolidated reports its taxable income and expenses under the accrual method of tax accounting. Section 446(c)(2) of the Internal Revenue Code of 1954 ("Code"). Consolidated has accrued its liabilities for worker's compensation consistently since 1970 in accordance with present law. Generally, Consolidated accrues and deducts its liabilities for worker's compensation in the year an employee is injured. No accrual is made for any contingent or contested liabilities. A deduction is taken for contingent or contested liabilities only when an amount is paid, the contingency is removed, or the contest is resolved. The amounts of the liabilities accrued are computed with reasonable accuracy.

The subject before this Subcommittee, "The Timing and Measurement of Taxpayer Deductions for Obligations to be Paid in the Future", is at the heart of our income tax system. As you know, the Administration has proposed fundamental changes in the system of tax accounting for the deduction of accrued expenses. Our comments focus on the Administration's proposal that the "all events" test for accrual of deductions would provide that no deduction will be allowed until what Treasury calls "economic performance" has occurred. This proposal is based upon the Treasury's perception that current deduction of liabilities to be paid in the future produces unintended benefits for taxpayers and upon its concern regarding so-called "reserve accounting" methods.

The Administration's proposals raise issues of basic fairness and undermine the principle that expenses incurred are to be matched with income earned. Moreover, the proposal fails to distinguish between abusive misuse of the accrual principle, such as in the case of some tax-shelter research and development partnerships, and the proper use by many of this country's leading businesses of a method of accounting which accurately reflects their liabilities to their workers and others. We believe

that any overhaul of basic tax accounting principles should be done only with great effort and care, and particularly that tinkering with the basic principles of tax accrual accounting should not be done on a piecemeal basis.

Our comments are specifically directed to the accrual of worker's compensation liabilities. We submit that:

(1) worker's compensation liabilities are normal business expenses which are not tax shelters or tax motivated transactions;

(2) worker's compensation liabilities are required, regularly recurring, small payments which are basically different from structured settlements, decommissioning or reclamation expenses;

(3) current case law permitting accrual of worker's compensation liabilities is correct and provides adequate safeguards against abuse;

(4) the hypothetical assumptions underlying the time value of money proposals do not reflect actual business experiences and the Treasury's proposals would impose an unwarranted detriment upon normal business taxpayers, both large and small;

(5) the Treasury proposals overstate income by requiring income to be accrued but denying deductions until expenses are paid, violating the basis rule of tax accrual accounting which matches income earned with the expenses generating that income; and

(6) further study should be made of alternative proposals.

We also submit detailed recommendations regarding effective date provisins and transition rules.

DESCRIPTION OF WORKERS'S COMPENSATION

Law and Operations

Under state law each employer must pay worker's compensation to employees or their survivors who are injured or killed in the course of their employment. These mandatory State laws prescribe the amounts to be paid for certain injuries and the terms of payment. The states require employers to provided security for payment of worker's compensation either by furnishing proof of insurance or satisfactory security to operate as a self-insurer.

The clear and worthwhile purpose of worker's compensation laws is to provide the certainty that our working men and women will receive fair compensation when accidents or injuries occur during their employment which require medical attention or hospitalization, or which prevent them from continuing to work, or result in the loss of life or irreparable harm to their body. *By no stretch of anyone's imagination can worker's compensation liabilities be considered to be "tax shelters" or "tax-motivated transactions"*. To the contrary, worker's compensation insurance or self-insurance is required to conduct business operations and the expenses are normal, recurring business expenses.

Consolidated has its own claims department in Portland, Oregon for processing workers' compensation claims. It is self-insured for worker's compensation liabilities in 33 states, purchases insurance for such liabilities in 13 additional states, and administers claims via state agencies in four states. In those states in which Consolidated is insured it deducts the insurance premiums paid to the insurance company on the accrual basis for the period of the policy coverage. Consolidated's claims department processes all claims including those arising in states where it is insured.

Consolidated's financial reserves for worker's compensation liabilities have historically been determined as a percentage of payroll costs and included reserves for unfiled and unreported claims and for unspecified contingencies. By comparison, Consolidated accrues its liabilities for worker's compensation in computing taxable income only for each individual filed claim. Liabilities upon such claims which are contingent or contested are not included. Therefore, the amount of Consolidated's financial reserves for worker's compensation liabilities greatly exceed, by approximately 60%, the liabilities accrued in compting taxable income. The difference between Consolidated's financial reserves for worker's compensation liabilities and the amount it accrues for such liabilities in computing taxable income demonstrates that the tax deductions are much, much more limited than financial accounting requirements and dispels the view that tax accrual of worker's compensation under present law is similar to the reserve method of accounting rejected by Congress with the repeal of Section 462 in 1955. P.L. 84-74, 69 Stat. 155 (1955). Suggestions to the contrary in recent testimony before the Committee on Ways and Means by the Assistant Secretary of the Treasury for Tax Policy are, with all due respect, incorrect. *See* Statement of John E. Chapoton Before the Committee on Ways and Means, February 22, 1984, pp. 4-5.

Typical worker's compensation liabilities

It is most important that you understand the nature of liabilities for worker's compensation. There are several types of liabilities which vary substantially.

(1) The most tragic and significant liabilities are for the death of an employee (death benefits). In that event, an employer is liable for payments of a fixed amount to the surviving spouse and children in addition to payments for medical, hospital and funeral expenses. State laws vary but the typical liabilities to surviving spouses are a fixed amount paid each month for life which terminates upon remarriage. Many states require paymens of benefits to a surviving spouse for a fixed number of years even after remarraige. The amount of the monthly payments is established by state law and based upon the salary and/or years of employment of the deceased employee. It may be subject to upward adjustment for inflation and other factors.

A typical worker's compensation case involving death benefits is as follows:

In December, 1983, Mr. Jones is killed in the course of his employment. He is survived by his widow, age 32, and three minor children ages 2, 4, and 8. Under the laws of State X, the widow is entitled to receive worker's compensation benefits of $350 per month for the rest of her life unless she remarries. If she remarries she is entitled to receive benefits for two years, which may be payable to her estate if she dies prior to the end of the second year. Each minor child is entitled to receive worker's compensation benefits of $100 per month until they reach age 18.

The liabilities to Mr. Jones' survivors fixed under state law are as follows: Widow (72 year life expectancy), $168,000; two year old child, $19,200; four year old child, $16,800; and eight year old child, $12,000. Of the $168,000 liability to the widow only $8,400 is accrued because the portion in excees of two years is contingent upon her failure to remarry. The total financial reserve established for this claim is $216,000, of which only $56,400 is accrued in computing taxable income.

(2) The least serious liabilities, although substantial in aggregate dollar amount, are for medical and hospital expenses for injuries which do not result in any disability ("medical only" benefits). Upon the occurrence of any injury to an employee a report is prepared and medical care is obtained or recommended. Medical only claims are usually relatively small in amount and paid within a short period after the injury occurs. Consolidated has substantially reduced the number of "medical only" claims within the last three years by providing more first aid treatment on the job.

(3) Injuries which result in full or partial temporary disabilities create liabilities for worker's compensation for such disability in addition to medical and hospital expenses. During the period the employee is unable to perform his normal duties the employer must make weekly payments of worker's compensation. The amounts are prescribed by state law based upon the degree of disability (seriousness of the injury) and/or the salary and experience level of the injured employee. The period of temporary disability is determined to end when a doctor certifies the employee can return to work or that the disability has become permanent. The vast majority (75% to 80%) of temporary disability payments are completed within six weeks. Temporary disabilities which last longer than six weeks may require payments for up to one to two years.

(4) Employees also suffer injuries which leave them permanently disabled either partially or totally. Such injuries create liabilities for worker's compensation in addition to medical and hospital expenses. These liabilities are similar to temporary disability liabilities although of longer duration and greater amount. The amount is prescribed by state law based upon the degree of disability and/or the salary and experience of the injured employee. States may require that these liabilities be resolved by lump-sum payments in case of hardship and such settlements may be negotiated in other cases subject to review by state agencies. In addition, liability for retraining or rehabilitation expenses may be incurred because of such injuries.

A typical temporary disability case which becomes a permanent disability is as follows:

Mr. Smith is struck on the shoulder and back by a heavy crate. He cannot move his right arm and shoulder and complains of back pain. He is immediately taken to a hospital and placed under a doctor's care. The doctor says that Mr. Smith will not be able to return to work for 4 weeks and that he will undergo treatments, X-rays, etc. during that period. At this point, liabilities are accrued for the medical and hospital expenses of $800 and for 4 weeks temporary total disability of $600 ($150 per week).

At the end of the third week, the doctor advises that Mr. Smith will not be able to return to work for an additional 8 weeks and that additional treatment is required. Additional amounts are accrued for medical expenses and 8 weeks temporary disability payments, $1,200.

After Mr. Smith has been on temporary disability for 10 weeks he claims that he is permanently disabled and cannot return to work. Consolidated requests a report from his doctor and also requests that a second medical opinion be obtained. Mr. Smith's doctor reports that Mr. Smith is indeed permanently disabled. (He is age 50 and his life expectancy is 70.) The second doctor confirms that Mr. Smith is unable to return to work for an additional 4 weeks but concludes that Mr. Smith is not permanently disability. Based upon these new facts, additional medical expenses and additional temporary disability liabilities may be accrued. An amount is determined for the claim of permanent disability which is included in financial reserves, but it is not accrued because such amount is contested. Later both doctors and the company agree that Mr. Smith is permanently disabled and the contest is resolved. At this point permanent disability liability of $200 per week for his 20 year life expectancy (for a total of $208,000) is accrued.

This liability requires weekly payments of $200 per week for 20 years. The present discounted value of those payments is $119,870 at a discount rate of 5.94 percent. The difference (or perhaps, more properly, only the tax savings thereon) is an amount which the Administration considers to be a "windfall" to the taxpayer. The proposal to restrict deductions to the cash method would permit deduction of only a maximum of $10,400 in the year the injury occurred and, thus overstate income in that year by $197,600 on the full face value basis or $109,470 on a discounted present value basis. The result of the Administration's cash method proposal would thereby result in a "windfall" to the Treasury by comparison to any proper matching of expenses of the period with income earned from such activities during the period.

Determination of amount of accrued liability

Consolidated employs a staff of 10 expert worker's compensation examiners. Most have substantial experience in the insurance industry. The examiners specialize in laws of specific states and are thoroughly familiar with medical terminology. Reports of injuries and claims for benefits are immediately provided to the examiners together with any invoices for services or treatment rendered. Based upon the nature of the injury and the laws of the state of jurisdiction, the liability for the injury is determined. Liabilities contingent upon remarriage of a surviving spouse and liabilities which are contested are separately noted and no accrual is made for such amounts although financial reserves are established for such liabilities.

It is important to understand that determination of the amount of worker's compensation liability is not a static process. As additional information is obtained, the claim file is reviewed and the amount of liability may be increased or decreased. Upon receipt of a claim or an injury report an examiner is able to determine the liability for the initially required medical treatment and whether the employee will be unable to return to work immediately. The latter fact determines liability for temporary disability payments. (In all but a few cases, it is easy to determine whether there is liability for the injury. In those few cases, the fact of the employer's liability is contested and because it is contested no amount is accrued in determining taxable income, although an amount may be set aside in financial reserves.) Immediately following receipt of the injury report, a medical examination is conducted and a report obtained from a doctor. This report specifies the medical treatment required and the time when the employee will be able to return to work. Based on this report, the amount of liabilities may be increased or decreased and the period of temporary disability may be redetermined and adjustments made to the accrual. Similar medical examinations and reports continue to be received throughout the period of a claim and appropriate adjustments are made on the basis of such examinations and reports. Additional adjustments are made based upon invoices received and payments for services if they vary from the medical reports.

All claims are reviewed by Consolidated's staff on a quarterly basis and at the end of the year. The year end review is particularly meticulous because it is the basis for the tax accruals. Large or complex claims are also reviewed by an expert committee of specialists in claims and employee benefits. Mr. Young is one of the members of that review committee.

The amounts of liabilities including the amounts accrued in computing taxable income are regularly audited by Consolidated's internal audit staff and Consolidated's independent public accounting firm.

Thus, an accrual for worker's compensation liability is not establishing a fixed amount upon occurrence of the injury which is unchanged, but establishing amounts based upon the best information available which is updated on a continuous basis to insure the accuracy of the accural. A test of accuracy based upon a comparison of the initial amount accrued to the total amount ultimately paid will

almost invariably show that less was accrued than paid. The amounts paid based upon the medical treatment required and disability established based on the initial reports will, however, be extremely accurate. The process of establishing an accrued liability and adjusting the amount as additional facts are obtained is squarely within the tax accrual accounting method established in Treasury Regulations § 1.461-1(a) which provides as follows:

Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

* * * * * * *

While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, *the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.* For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. *Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.* (Emphasis supplied.)

A comparison of the method of accruing liabilities for worker's compensation previously described with the requirements of the Regulations makes it clear, as the courts have held, that it is squarely within the rules of accrual tax accounting.

TAXATION OF WORKER'S COMPENSATION LIABILITIES UNDER PRESENT LAW

A business subject to worker's compensation liability under state law must provide for satisfaction of that liability either by contracting with a worker's compensation insurance carrier, by establishing a qualified self-insurance program (under which the business itself will pay any liability imposed on it under the applicable state laws), or by a combination of insurance and self-insurance. The Administration's proposals only affect taxpayers who are self-insured and report taxable income upon the accrual method.

Deduction of expenses under the accrual method is proper when (1) all of the events that bear on the fact of liability have occurred and (2) the amount of liability has been determined with reasonable accuracy. *United States* v. *Anderson*, 269 U.S. 422 (1926); Regs. § 1.461-1(a)(2) (1983). There has been significant controversy regarding the types of worker's compensation liabilities which may be accrued and deducted under this two-pronged test. Nevertheless, under the prevailing interpretation of the law, a carefully administered system of accruing worker's compensation liability in cases where the fact of the employer's liability is uncontested satisfies both prongs of the test.

The Internal Revenue Service has long contended that most worker's compensation liabilities do not satisfy either prong or the *Anderson* test. However, the Service has agreed that taxpayers may accrue worker's compensation liabilities established by an award in the year of the award. Rev. Rul. 69-429, 1969-2 C.B. 108. The Service has viewed events occurring after an employee's death of injury as "contingencies" upon which the employer's liability depended. For example, the Service has contended that liability for medical care is not established until after such care has been provided (Rev. Rul. 80-191, 1980-2 C.B. 168) and that an employer's liability to make payments until their nineteenth birthday to children surviving a deceased employee was not established because the children could die earlier (Rev. Rul. 70-262, 1970-1 C.B. 122). Initially, some judges of the Tax Court accepted the Service's arguments. *Thriftimart, Inc.* v. *Commissioner*, 59 T.C. 598 (1973); *Crescent Wharf & Warehouse Co.* v. *Commissioner*, 59 T.C. 751 (1973), Rev'd 518 F.2d 772 (9th Cir. 1975).

Almost simulataneously with the *Cresent Wharf & Warehouse* decision, another Tax Court decision reached an opposite conclusion, permitting accrual of liabilities to surviving children of a deceased worker on the ground that the employee's death established the fact of the employer's liability to the children. *Wien Consolidated Airlines, Inc.* v. *Commissioner*, 60 T.C. 13 (1973), aff'd 528 F.2d 735 (9th Cir. 1976). Both cases were appealed to the Ninth Circuit Court of Appeals.

The Ninth Circuit held that accrual was permissible under the "all events" test because the fact of injury to an employee in an uncontested case is sufficient to es-

tablish the employer's liability. (Deductions for contested liabilities were not claimed until the contest was resolved.) The court found that liability for medical service and loss of time from work was fixed at the moment of injury, and that only the amount of the liability was not absolutely certain at the moment of injury. *Crescent Wharf & Warehouse,* 518 F.2d at 774. Likewise, liability to the surviving children of a deceased employee was fixed at the moment of the employee's death and only the amount of that liability would be affected if the children died before their nineteenth birthday. *Wien Consolidated Airlines,* 528 F.2d at 737–38.

As noted above, the "All events" test requires more than a fixed liability as a prerequisite to a deduction. In addition, the amount of the fixed liability must be determined with reasonable accuracy. Thus, a reserve based on a rough estimate of worker's compensation liabilities is not deductible, but a deduction is permitted when the amount of liability, though not determined down to the penny, is determined in a careful, objective manner which results in a resonably accurate calculation. For example, in *Wien Consolidated Airlines, Inc.* the taxpayer sought to accrue and deduct two types of accrued liability: (1) for payments to children of deceased employees, which would continue until each child's nineteenth birthday or death, whichever came first, and (2) for payments to widows of the employees, which would continue until the earlier of death or remarriage. The Ninth Circuit, noting that there is over a 97% chance that an infant in the United States will survive past age 19, approved accrual of the children's benefits on the basis that they would live to reach 19. Noting the absence of any evidence of similar probabilities regarding remarriage of widows, the court refused to allow deduction of an accrual based on life expectancies of the widows because of the contingency that payments would terminate upon remarriage. The first accrual, for benefits to the children, was determined with reasonable accuracy. The second, for benefits to the widows, was not.

Thus, under present law only accruals supported by objective factual determinations are deductible. Where the objective impact of possible later occurrences cannot be reasonably accounted for, deduction of a liability may not be accrued for a fixed liability because the amount of liability cannot be determined with reason accuracy.

In short, *Crescent Wharf & Warehouse* and *Wien Consolidated Airlines* established that in a worker's compensation case the employer's liability was fixed at the time of injury, so that accrual of a liability for worker's compensation could be deducted provided that there was a resonably accurate determination of the amount of the liability. The Service issued Rev. Rul. 80–191, stating that it would not follow these cases. The Service litigated the issue again, and lost again in *Kaiser Steel Corporation.* The Service has not yet indicated whether it will follow *Kaiser Steel Corporation,* although the government has decided not to seek review of the Ninth Circuit's decision. Despite the Service's position, the courts have approved deductions based on objective calculations of liability where no deduction is taken for contested or contingent liabilities. A major basis for the courts' opinion has been that the accruals are proper under the Code and Treasury Regulations and that accrual of the liabilities at the time of injury is required to properly match income and expense. As the Ninth Circuit stated in *Crescent Wharf & Warehouse:*

The most logical correlation of income to expenses would be by deducting in the year the injury was sustained the employer's liability actually paid or which was accrued with reasonable accuracy as arising out of that injury. 518 F.2d at 775.

PRESENT LAW SHOULD NOT BE CHANGED

The present accrual tax accounting rules for worker's compensation and similar liabilities should not be changed in the manner described in the Administration's proposal. The Administration proposes to require employers to use the cash accounting method (labelled an "economic performance" redefinition of the "all events" test) for major expenses, while maintaining an accrual method for reporting income. Far from fairly reflecting the time value of money, the proposal results in an income distortion—with income reported in earlier years (as accrued) and expenses in later years (as paid). If a statutory change in the tax accounting rules is made, it should be to provide clearer statutory authority for accrual of worker's compensation liabilities in the year the injury is incurred consistent with basic principles of matching income and expenses of a period.

The cash method proposal goes much too far

At the outset it should be recognized that the Administration's proposal to require accrual method taxpayers to deduct worker's compensation liabilities only when payment is made which extinguishes the liabilities only when payment is made which extinguishes the liability to the claimant goes much too far. Although the Treasury Department calls this accrual of liabilities upon "economic performance,"

it is clear that their proposal is nothing more or less than to require worker's compensation liabilities to be deducted only on the cash method—when payment is made. "Revenue Proposals Contained In the Administration's Fiscal Year 1985 Budget: General Explanations," Department of the Treasury (Feb. 17, 1984), Item D. 2.a., p. 2. There is no reason why an accrual basis taxpayer should not be permitted to accrue hospital and medical expenses once a statement (invoice) is received or temporary or permanent disability payments once the period of disability has occurred. Such accrual of expenses would be allowed even under the restrictive position argued by the Service. See Rev. Rul. 80-191, supra. Normal accrual rules are proposed for other liabilities. No explanation is given as to why worker's compensation liabilities should be less favored than the other accruals. That is particularly strange because it is the other liabilities which most neatly fit within the Administration's hypothetical example. The failure to allow deductions for accrued expenses for worker's compensation upon the same basis as allowed for coal mine reclamation expenses (when land is reclaimed) and nuclear power plant decommissioning expenses (when the plant is decommissioned) demonstrates the danger of proceeding too hastily without full and fair consideration.

Another point regarding the Administration's proposal to redefine the all events test to require "economic perormance" (which in the case of worker's compensation is defined as "when payments are made extinguishing liability to claimants") is that it may prevent deductions when payments are made to an appropriate trust authorized by Section 501(c)(9) or Section 461(f). Such a result would be extremely unfair because under either procedure the taxpayer has paid the money to a trust sanctioned by the Code to insure that the liabilities are paid. Deductions for such payments would be permitted under current law and the Administration's proposals do not address those issues.

Accrual for worker's compensation liabilities is not a "tax shelter" nor a tax motivated abusive situation

Liabilities for worker's compensation payments arise upon an injury to an employee. *Kaiser Steel Corp.* v. *United States,* 717 F.2d 1304 at 1306-07 (9th Cir. 1983) and *Crecent Wharf & Warehouse Co.* v. *Commissioner,* 518 F.2d 772 at 774 (9th Cir. 1975); *Wien Consolidated Airlines, Inc.* v. *Commissioner,* 528 F.2d 735 at 737-38 (9th Cir. 1976). The amounts of liabilities are prescribed by state laws and are determined with reasonable accuracy. Id. Worker's compensation liabilities are far removed from structured settlements in which one taxpayer with a present liability persuades another taxpayer to accept a larger amount payable years in the future. Moreover, worker's compensation liabilities are different from coal mining reclamation expenses or nuclear power plant decommissioning expenses in that the injury has occurred at the time of accrual whereas the reclamation or decommissioning has not. In addition, payments have been and continue to be made on a frequent, regular basis upon worker's compensation liabilities beginning at the time of accrual. They are not large, future payments which may never be paid. Instead they are a stream of small regular payments which are being paid weekly or monthly.

Payment of worker's compensation to injured employees is a desired societal goal adopted by all states. It is a valuable and needed social program carried out by the private sector pursuant to state law. The present tax law encourages periodic payments of worker's compensation benefits by properly allowing a deduction for such liabilities in the year the injury occurs. If the Administration's cash basis proposal is adopted, employers must earn much more in the year of injury to fund payment of worker's compensation benefits properly chargeable to that period.

In a troubled or break-even operation, the very ability of employers to make future payments of worker's compensation will be impaired by the proposal. Part of any income which would be set aside to provide for future satisfaction of the liability will have been taken by the government as a premature tax. Thus, in the above example of a disability claim, to pay $10,400 to Mr. Smith in the year following the injury, the employer would ordinarily be expected to set aside in the year of injury the present value of the payment to be made in the following year. However, part of this amount must be paid to the government to satisfy the artificially inflated tax liability. As a result, the employer is left without enough available cash to set aside and earn a return sufficient to satisfy the liability. In the example, the process of premature taxation would consume the fund approximately as follows:

Amount of liability	$10,400
Increase in tax in year of accident resulting from failure to match income and expense (at 46 percent)	4,784
Remainder available for payment	5,616

Return on investment (at 6 percent after tax rate)	337
Amount available to make payment	5,953

Thus, under the Administration's proposal, the taxpayer would be left over $4,000 short of the amount necessary to make the payment.

The Administration would seek to minimize the possibly disastrous consequences of such a tax-induced shortfall by permitting quick refunds of net operating loss carrybacks and by proposing an amendment to the carryback rules to allow losses arising in the year of payment to be carried back more than three years. Unfortunately, this proposal does little to addresss the disastrous consequences of premature taxation or the underlying unfairness of the Administration's proposal.

First, it should be noted that inclusion of the carryback extension in the proposal is an implicit recognition that the overall proposal results in mismatching of income and expenses. Moreover, it is a recognition of the fact that in many cases the expenses, attributable to income earned in earlier years, would be deferred into a year where there is no income earned to absorb them.

The availability of a net operating loss carryback would not compensate the taxpayer for the use by the government of the tax dollars generated by mismatching of income and expenses. A taxpayer filing a claim for a net operating loss carryback refund is not entitled to interest on the refund for the period between the original payment of the tax and the filing of the net operating loss refund claim. Section 6611(f)(1).

In addition, in a truly critical situation, it is conceivable that the tax-induced shortfall could not be overcome by a quick refund of a net operating loss. First, such a claim cannot be filed until the end of the taxable year in which the payment is made. Section 6411(a). Before then, the taxpayer must find another source of funds or default on its obligation. Second, if the taxpayer cannot afford to make the payment, no deduction for the payment can be taken and the tax-induced shortfall cannot be recovered. While it would certainly be an extreme case in which other funds could not be used to make the payment, the fact that the proposal would force the taxpayer to generate or borrow additional funds illustrates the unfairness of the proposal.

Under present law the service and the courts can control abuses

Unless a taxpayer has already adopted the accrual method for worker's compensation liabilities, it must obtain the consent of the Commissioner to change its method of accounting. Under these procedures, the Commissioner can control the numbers of taxpayers who adopt the accrual method.

The amounts accrued must be capable of computation with reasonable accuracy. Treas. Regs. § 1.461-1(a); e.g., *Kaiser Steel Corp.* v. *United States*, 717 F.2d 1304 at 1308 (9th Cir. 1983). In a recent case involving accrual of worker's compensation, the trial court held accrual was improper because the Commissioner's consent to a change of accounting method had not been obtained and because the amounts were not computed with reasonable accuracy. *ESCO Corp.* v. *United States*, 83-2 U.S.T.C. ¶ 9714 (D.Ore. 1983).

If a taxpayer should increase the amount of an accrued liability in order to obtain a greater tax deduction, the deduction may be disallowed as not constituting an ordinary and necessary business expense. E.g., *Goldstein* v. *Commissioner*, 364 F.2d 734 (2d Cir. 1965), cert. denied, 385 U.S. 1005 (1966).

Finally, deductions have been and can be disallowed if the time for payment is too remote, *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1969), or the amounts accrued might not be paid, *Southern Pacific Transportation Co.* v. *Commissioner*, 75 T.C. 497 (1980); *World Airways, Inc.* v. *Commissioner*, 564 F.2d 886 (9th Cir. 1977), aff'g 62 T.C. 786 (1974); see *Burlington Northern Railroad Co.* v. *Commissioner*, 82 T.C. No. 13 (Jan. 24, 1984).

The time value concept is highly complex and hypothetical

Underlying the Administration's time value of money proposals is the concept that taxpayers should only receive the current benefits of a discounted present value deduction of liabilities to make future payments. Indeed a proposal to permit such deductions was considered by the Treasury and Senate Finance Committee. It has now, however, been abandoned because it was too complex. Fairness or unfairness in the tax law should not be determined upon comparison to a result too complex to propose.

Such complexity demonstrates the real life fallacy of the assumed hypothetical example utilized to describe the time value of money proposals. What interest rate should be used? The choice of an interest rate and after tax discount rate will make

tremendous differences in the results. Our experience, particularly recently, is that interest rates fluctuate frequently and by extreme factors. Should the computations of deductions or concepts of relative fairness or benefit fluctuate on such whims? Can businesses operate on that basis? Of course not.

Another difficulty with the Administration's time value of money concept is that it relies upon examples whereby an amount is accrued and deducted in one year and no payments are made until ten or more years later. Upon such hypothetical facts, it is easy to conclude that there is a benefit to the current deduction and use of the taxes saved over the period before payment is required. Worker's compensation involves a series of accruals over a period of time and regular weekly or monthly payments. Thus, worker's compensation liabilities do not fit neatly within the hypothetical example and, as illustrated previously, the Administration's proposals may cause real hardship where the time between accrual and payment is relatively short.

Perhaps in an ideal world discounted present value computations would be made for each payment made or received whether expense, capital or income. We would then have a perfect accrual accounting system attuned to the time value of money. As Treasury admits, such a system is not workable in the real world. Thus, it should not be used as a standard against which to measure our present tax system, which is designed to collect a fair tax on real income.

The Kaiser Steel Corporation decision

The substantial power the Commissioner has to withhold consent to change a method of accounting and the judicial restrictions described above are sufficient to prevent any abuse of the accrual accounting method for worker's compensation. This leads to the conclusion that the Treasury Department's concern is with the scope of the recent decision in *Kaiser Steel Corporation* v. *United States*, 717 F.2d 1304 (9th Cir. 1983) by comparison with the prior opinion of that same court in *Crescent Wharf and Warehouse Co.* v. *Commissioner*, 518 F.2d 772 (9th Cir. 1975).

First, to the extent the *Kaiser Steel Corporation* opinion can be read to authorize accrual for contingency reserves it does go too far. We do not believe it authorizes any such accrual of contingency reserves. The Ninth Circuit in *Kaiser Steel Corporation* applied the "all events" test of *United States* v. *Anderson*, 269 U.S. 422 (1926) and Treasury Regulations § 1.461-1(a)(2). It did not abandon that test and conceive a new "reserve" accounting method. Contrary to the government's arguments in that case and prior cases, the Ninth Circuit held that the fact which establishes liability is the injury to the employee. Other subsequent facts, such as the costs of medical treatment and period of disability do not determine the fact of the employer's liability—only the amount of that liability. An accrual of worker's compensation liabilities for each injury suffered and claim made against an employer should be allowed. That is the rule established in *Crescent Wharf and Warehouse Co.*

The *Kaiser Steel Corporation* opinion does state that the reasonable accuracy of the taxpayer's accruals may be judged by comparing the total payments on claims against a taxpayer to the total amounts accrued by the taxpayer. As explained previously, a specific comparison of the initial accrual upon a claim with the total payments on a claim is not meaningful. This is true because frequent adjustments are made to the amount initially accrued on an individual claim based on new facts and information. Thus, the total payments upon a specific claim will correspond precisely to the initial accrual as subsequently adjusted. To measure the accuracy of the accrual at any time in the process of a claim the reasonableness of the accrual can be determined upon an evaluation of the facts then known. Failing such a detailed examination of the status of each claim at a particular point in time, it is entirely appropriate to compare aggregate accruals and aggregate payments and we assume that such comparison was considered by the parties and the courts for convenience.

The previously described difference between the amount of accrual for worker's compensation liabilities and the amount of financial reserves for worker's compensation liabilities makes it clear that accrual of worker's compensation liabilities is not, in fact, a return to a financial reserve method of accounting.

Tax accounting methods should not be changed on a piecemeal basis

It is important to bear in mind that a method of accounting is exactly that—a method. To change one specific item without an examination of the entire method will promote unfair results which will distort income. Full consideration of a tax accounting method which takes into account the time value of money should consider income and capital items as well as selected expense items. A full range of options should also be presented regarding expense items. Thus, depreciation deductions based upon replacement costs should be considered. Such a project may indeed

be worthwhile, but we submit that there is a long way to go before any sound conclusions can be reached.

Taxpayers must perceive the Administration's proposals to be unfair. As to worker's compensation liabilities, the Administration's proposals are essentially that the taxpayer must accure income but may not accrue expenses. This clearly produces a mismatching of income and expenses which any rational accounting method should try to avoid. See Aidinoff and Lopata, "Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future," 33 *Tax Lawyer* 789 at 796-97 (1980).

Such a matching principle has been long recognized by the courts. E.g. *United States* v. *Anderson*, 269 U.S. 422 (1926). Indeed, the basic idea of an accrual accounting method is that expenses definitely incurred should be reflected "without regard to whether payment has been made or whether payment has been made or whether payment is due." *H.H Brown Co.*, 8 B.T.A. 112, 117 (1927), acq., VII-1 C.B.5. The more restrictive Internal Revenue Service view has been criticized by commentators and rejected by the courts. Aidinoff and Lopata, supra, at p. 797-800; *Kaiser Steel Corp.* v. *United States*, supra, *Crescent Wharf and Warehouse Co.*, v. *Commissioner*, supra.

The proposed change will compel taxpayers to purchase insurance coverage

If employers cannot accrue worker's compensation liabilities, but insurance companies can, an unfair distinction will be created between insured and self-insured coverage. The amount deducted for future payment of worker's compensation claims by insurance companies is as great or greater than self-insureds under present law. The annual expense (or income which must be earned to fund worker's compensation) is too great to bear without a tax deduction. As a result many taxpayers will shift to insurance in whole or in part. This is an unwarranted and undesirable result because self-insured employers are frequently more safety conscious, more responsive to employee needs and less expensive. Indeed, if a shift to insurance occurs there may well be a revenue loss instead of a revenue gain because the premiums will be approximately 40 percent greater that the amounts presently accrued by self-insured taxpayers and the insurance company may deduct greater reserves.

IF PRESENT LAW IS CHANGED ALTERNATIVES TO THE CURRENT PROPOSAL SHOULD BE CONSIDERED

Accrual of discounted present value

The Administration has considered, but not presented, an election to accrue the discounted present value of future payments. We suspect it was abandoned because it is less favorable to taxpayers than the cash method and because the complexity of required adjustments reflecting real life situations would demonstrate conclusively the unfairness of the proposal. The concept, however, is the Administration's standard for determining the fairness of present tax results. For that reason, we believe that this Subcommittee should examine this proposal and the Administration's prior efforts. Under such a proposal, the discount rate should be an after tax rate and should be the stated interest rate in Section 6621 times 100% less the maximum stated tax rate, currently 46% for corporate taxpayers. At present the proper after tax discount rate would be 5.94% (11% interest rate times 54%, i.e. 100% less that 46% tax rate). Lest this be considered a simple and obvious method of accounting for the time value of money, it should be noted that the potential problems with such a rule are substantial. It is a harsh rule which does not permit taxpayers to deduct the full face value of their expenses nor if it clear what result would follow if future payments were increased because of inflation, etc. See Aidinoff and Lopata, "Section 461 and Accrual Method Taxation: The Treatment of Liabilities Arising from Obligations to be Performed in the Future," 33 Tax Lawyer 789 (1980).

Amend section 501(c)(9)

Another alternative the Subcommittee may consider is to amend Section 501(c)(9) to permit taxpayers to pay funds into a trust to provide for payment of future worker's compensation liabilities. Presumably the amounts paid into the trust would be the discounted present value of future claims plus the full amount of claims to be paid within the near future, for example five years. Amounts withdrawn from the trust by the employer, if any, would be taxable income in the year received.

Adopt an arbitrary time period

Another proposal considered by the Administration and others is to adopt an arbitrary time period for the accrual of future payments. See New York City Bar Report, "Transactions Involving Deferred Payment of Accrued Liabilities: Federal

Income Tax and The Time Value of Money," 20 Tax Notes 699, at 714 (Aug. 29, 1983). If such an approach is adopted the proper period should be carefully considered. A more appropriate period than the one year period previously considered would appear to fall between three and five years.

Permission to change to the cash method

If the Treasury Department's proposal to require accrual method taxpayers to report worker's compensation liabilities and similar liabilities only when claims are paid (i.e., the cash method) is adopted all affected taxpayers should be authorized to elect to report all income and expenses on the cash method within prescribed time limits.

TRANSITION RULES

Effective date

It is recommended that any changes be effective for injuries occurring in taxable years beginning after December 31, 1984 (or the end of the calendar year in which changes are enacted, whichever is later). The effective date should apply to injuries occurring after a certain point in time. Under present law, it is the date of injury which fixes the time for accrual. Obviously, the required changes in accruals could be made most efficiently at the end of an employer's taxable year. Under this approach, a calendar year taxpayer would continue to report under present law for its taxable year ended December 31, 1984 and would apply the changed rule beginning January 1, 1985. A July 1–June 30 fiscal year taxpayer would continue to report under present law for its taxable year ended June 30, 1985 and would implement any changes thereafter. If amendments are not enacted in 1984 the effective date provision would operate following the end of the calendar year of enactment. This recognizes the need for advance notice to taxpayers and the fact that accrual of worker's compensation liabilities is not a tax shelter nor a tax motivated transaction. It is unreasonable to expect that employees are going to suffer injuries simply to take advantage of a future effective date.

Present law continues to apply to prior injuries

Injuries occurring prior to the effective date should continue to be subject to present law. This should include subsequent adjustments to the accrued liability as additional or new information is obtained. Thus, injuries occurring prior to the effective date would continue to be reported as accrued liabilities after the effective date including increases or decreases in the accrued amount.

Section 481 adjustment for cash method

In the event that the Administration's proposal to require employees to report their liabilities for worker's compensation under the cash method of accounting is enacted the normal relief furnished to taxpayer's forced to change their method of accounting should be provided. Section 481. In this case, under Section 481, the taxpayer would begin to deduct worker's compensation liabilities upon payment as of the beginning of the taxable year in which the change is effective. The taxpayer would deduct all payments, including those related to claims previously accrued. To eliminate a double deduction, the accrued liabilities at the end of the preceding taxable year would be restored to income ratably over the period of years (not to exceed ten) the taxpayer had consistently reported income under the prior (accrual) method. See Section 481(b)(2) and Revenue Procedure 80–51, 1980–2 C.B. 818.

Grandfather provisions

Taxpayers who are properly accruing liabilities for worker's compensation under present law should be permitted to continue to accrue liabilities for worker's compensation. This is similar to the rules applied to accrual of vacation pay when restrictions upon accrual of vacation pay were enacted. See Section 463; see also Technical Amendments Act of 1958, § 97.

Estimated tax payments

If changes are made it should be made clear that taxpayers who have relied upon present law in making estimated tax payments are not subject to penalties or interest if their estimated tax payments are less than they should have been as a result of this change in the law.

CONCLUSION

We appreciate the opportunity to present our views. The subject before this Subcommittee is complex and important. It deserves full and complete consideration

before any changes are made requiring that different accounting methods be used by taxpayers. Insofar as worker's compensation is concerned, it is clearly not a tax shelter nor a tax motivated abuse and the proper answer requires careful balancing of the interests of the government to provide a fair tax system with encouragement for compensation of injured workers and promotion of efficient self-insured programs.

We will be happy to answer any questions now or by supplemental written comments and to work with your staff.

Thank you.

Chairman RANGEL. Mr. Reeves.

STATEMENT OF ROBERT A. REEVES, PRESIDENT, HEALTH SERVICES GROUP, HOSPITAL CORP. OF AMERICA

Mr. REEVES. I am president of the Health Services Group, Hospital Corp. of America, Nashville, Tenn.

The Hospital Corp. of America operates 390 hospitals in the United States. One of my responsibilities is insuring the corporation. My purpose today is to discuss briefly with you one specific concept, and that is the need to allow tax deductibility of loss reserves to be set aside to cover expenses and losses that businesses can actuarially determine with reasonable accuracy that will be paid in future years, but due to events have occurred this year. Unlike the proposal in the oral statement by the architects and engineers, we are not talking about events that may occur in some future year, but reserves set aside for events that have occurred this year.

The tax treatment for defined self-insurance reserves which are the functional equivalent of purchasing insurance policies for predictable losses has been denied by the IRS and by some Federal courts, except we are making some inroads in the area of worker compensation such as with the *Kaiser Steel* case. Therefore, in our opinion, it is essential that Congress enact legislation that will allow us such deductions.

Self-insurance reserves look, feel and smell like reserves that are held by insurance companies. They just happen to be held by a different entity and should be accorded the same tax treatment.

All companies must deal with risks which are the uncertainties of business. The primary means of financing claims due to risks encountered by companies is to purchase insurance for a fixed fee that obligates the insurer to pay expenses and claims attributable to specific acts or circumstances.

Companies strive to handle the financing of these claims in the most efficient manner. Traditional risks are handled through the purchase of insurance where the law of large numbers works, and insurance premiums collected by the company from the many pay the losses of the few.

In recent years, many companies, in order to keep costs at a reasonable level, have chosen to self-insure a portion of their own risks using a similar technique that you do in selecting the deductible on the collision insurance policy on your car.

Often, these corporations, with a reasonable degree of accuracy, can predict the cost of claims to be paid under these deductibles for incidents that occur in any particular year.

For instance, in Hospital Corp. of America's efforts to keep health care costs at a reasonable level since 1976, our malpractice

insurance costs increased over 20 percent and we chose a deductible in our malpractice insurance policy.

In order to keep those costs at a reasonable level, that deductible now has increased to $1 million for any malpractice insurance claim. Since 1977, we have had 4,769 liability insurance claims, including malpractice under this million dollars.

In 1983, we set aside $22,258,381 to cover the cost of malpractice claims that actuarially were predicted that will hit us in 1983.

Corporations, due to the position taken by the Internal Revenue Service, must set aside these reserves in after-tax dollars rather than pretax dollars. The accounting protection under FASB-5 requires companies like us to set up these reserves, but accounting theory and tax theory in this area do not coincide.

Insurance can be a very expensive way to finance claims. In general, insurance companies spend 27 cents out of each insurance premium dollar for nonclaims-related expenses, leaving 73 cents to pay claims.

In our experience, you can administer a self-insurance program for between 5 cents and 7 cents of the equivalent amount to the insurance premium paid.

Many companies would like to more actively self-insure a portion of the risk, but the position by the IRS encourages the purchase of insurance, since premiums are tax deductible. There are no laws in the United States that require a corporation to purchase liability insurance.

If a corporation chooses not to buy insurance or insure a portion of its risk, the tax law should encourage responsible funding of such risk to insure that funds are available to pay claims which have been incurred against the manufacturer, but have not been paid.

Currently, the position taken by the IRS discourages the setting aside of funds, since such reserves must be established out of after-tax dollars.

We are headed for another malpractice insurance crisis. Mr. Gibbons, in your State, the Florida Patient's Compensation Fund is experiencing severe problems.

The other day in Miami, I received a call that physicians were threatening to go on strike due to increases in malpractice costs. Something must be done to contain the costs of malpractice insurance in the United States and contain health care costs.

The tax deductibility of actuarially predicted reserves for malpractice would assist us in that area. We also have worked with the risk and insurance management society on H.R. 2642, introduced by Representative Frenzel.

We think that self-insurance should be administered under a responsible bill. We have been working several years for that bill, which I encourage you to review, because the mechanism is simply administered and it is prudent. Mr. Duncan, you asked a minute ago about the set-aside of funds for people who may be injured now and not paid until the future. That bill requires self-insurers to set aside the fund in a trust and set funds aside so that the money will be available even if the manufacturer would go bankrupt, for instance.

That is the end of my statement.

[The prepared statement follows:]

STATEMENT OF ROBERT A. REEVES, PRESIDENT, HEALTH SERVICES GROUP OF THE HOSPITAL CORPORATION OF AMERICA

SUMMARY

(1) All businesses must deal with "risks" that could result in losses or payments of claims for liabilities incurred. Some such risks are covered by purchasing insurance policies. Others are "self-insured" by providing for reserves to fund the future payments.

(2) Self-insuring for actuarially predictable losses is a longstanding business practice that draws on the same professional expertise that enables insurance companies to predict claims and set premiums. This process saves the business the approximately 20% of an insurance premium that covers extraneous costs for administration, defense expenses, and brokers.

(3) Federal tax law discourages self-insurance by denying current tax deductions for self-insurance loss reserves while allowing deductions for payments of insurance premiums, even though the two practices are functional equivalents with respect to actuarially predictable losses.

(4) Federal tax law should be amended to allow current deductions for loss reserves for clearly defined self-insurable risks that give rise to actuarially predictable claims that will be payable in future years due to events occurring in the current year.

STATEMENT

Thank you, Mr. Chairman.

My name is Robert A. Reeves. I am President of the Health Services Group of Hospital Corporation of America in Nashville, Tennessee.

The subjects noted in the call for this hearing potentially touch a wide range of taxpayers in many different ways, as is apparent from the variety of witnesses before you. My purpose today is to discuss briefly with you one specific concept—the need to allow tax deductible loss reserves to be set aside to cover the expenses and losses that businesses can actuarially determine with reasonable accuracy will be payable in a future year due to events that occur in the current year. This equivalent tax treatment for carefully defined "self-insurance" reserves that are the functional equivalent of purchasing insurance policies for predictable losses has been consistently denied by the Internal Revenue Service and by some federal courts. Therefore, it is essential that Congress enact legislation that will allow such deductions.

My statement will briefly summarize the issues related to tax deductions for certain loss reserves and the specific legislative proposal that has been introduced as H.R. 2642 by Representative Frenzel. Attached to my statement is a more extensive memorandum on the issues and a technical description of H.R. 2642.

While I am presenting only the views of my company based on our own extensive experience, I am well acquainted with a number of companies in other industries that share our conviction.

THE SELF-INSURANCE PROBLEMS FACED BY BUSINESS TAXPAYERS

All companies must deal with "risks", which are the uncertainties that business entities encounter. The primary means of planning for risks is to purchase insurance for a fixed fee that obligates the insurer to pay for expenses and losses attributable to specific acts or circumstances. Alternatively, the business can "self-insure" by bearing the risk itself, in which case expenses and losses are paid or suffered by the business. Financial Accounting Standards Board standard no. 5 requires that self-insurers establish reserves for claims that have occurred but have not yet been paid.

Although self-insurance may not appear to be a common practice to the average observer, it is in fact practiced widely by businesses and individuals alike, even when insurance policies are purchased. For example, the $200 deductible on your automobile's collision policy and similar deductibles on your homeowner's policy are self-insurance features, as is the dollar amount above the maximum policy limits.

A principal objective of purchasing insurance is to pool one's risks of uncertain losses with other persons so that the insurer, rather than the business, must grapple with the uncertainties based on the statistical information available to it. When the risks are certain, that is, when a business knows from its own experience that a

predictable level of expenses and losses will occur due to circumstances that arise every year, the purchase of insurance policies no longer fulfills its primary purpose. Instead, the purchasing business is increasing the cost of the expenses and losses that it knows it will bear (which is represented by the major portion of the insurance premium) by amounts that are included in insurance premiums to cover the insurer's administrative costs, legal defense costs, brokers' fees, rating services, and other items. My experience strongly indicates that such costs are approximately 20 percent of the cost of insurance premiums paid by HCA to outside insurers.

The ability to project with certainty that a level of losses will arise in one year and then be identified and payable in another year is much easier to accomplish than is generally recognized outside the realm of professional risk managers. Virtually every business sector has, unfortunately, an actuarially predictable level of losses, whether it be malpractice claims in the medical care industry in which HCA operates, or fraud and embezzlement in financial services, or workers compensation in various manufacturing industries.

For example, the experience gained at HCA since we began to self-insure in 1977 allows us to predict with actuarial certainty that we will ultimately pay out $22,258,381 for claims and expenses relating to medical malpractice claims under $1 million incurred in 1983. (We purchase catastrophic coverage for the larger amounts.) Similarly, our experience with respect to workers compensation allows us to predict that $13,643,516 will be paid out for such claims incurred in 1983. Our ability to make such projections is based on 4,769 general liability and medical malpractice claims and 29,934 workers compensation claims since 1977. FASB No. 5 and responsible business practices require us to set aside these amounts in reserves.

Therefore, the practice of self-insurance by American business is based on extensive experience and has developed a considerable level of credibility and expertise. What is lacking at the moment is the ability to apply federal income tax law to self-insurance along the same lines as the tax treatment of purchased insurance.

FEDERAL INCOME TAX ISSUES CONCERNING SELF-INSURANCE

Insurance premiums

Payments of premiums for insurance policies generally are deductible in the year paid as business expenses under Code section 162. The risks covered for the policy year may or may not result in payments by the insurer in the year in which the premium was paid. In fact, it is unlikely that most risks involving third parties will result in claims being settled within the policy year. In many areas of risk, to achieve such a result would be a modern miracle, given the nature of legal/judicial processes these days.

Nevertheless, the business is allowed to take a deduction for insurance premiums with respect to insurance to cover expenses and losses arising from events in the current year, *even though* the loss may not be identified until a later year and certainly will not be payable until a later year.

Self-insurance

Similar treatment for self-insurance is vigorously opposed by the Internal Revenue Service. The history of taxpayer claims, IRS reactions and judicial determinations has drawn us to the conclusion that legislation is needed to provide a clear rule for the equitable tax treatment of certain self-insured business risks.

Self-insured losses generally are deductible under Code sec. 165(a), but the year in which the deduction is allowed depends upon the tax accounting practices of the taxpayer under Code sec. 461(a). For accrual method taxpayers, "an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determine with reasonable accuracy." Treas. Req. §1.461-1(a)(2).

The IRS and some courts have held that the "all events" test requires that the claim not be contested and that the "determined amount" test requires that individual claims, not aggregate liability, be identified as to their amounts.

These positions are serious inequities for self-insurers. Claims against a business will generally be contested by both a self-insurer and a commercial insurer. Therefore, the individual claims generally will not be fixed until a subsequent year, after the conclusion of litigation or negotiations. And, both the commercial insurer and the self-insurer are able to predict with a high level of confidence the nature and magnitude of losses that will occur in a particular year, even though the date of payments and identity of each claimant and amount may not be known for several months or years. If such certainty were not the case for large numbers of risks, com-

mercial insurers would not be able to quote premiums on an annual basis and stay in business.

However, the IRS insists on treating commercial insurance premiums as deductible business expenses while disallowing deductions for self-insurance loss reserves. The result is a double-barreled blow to efficient risk management. First, the business is encouraged by tax law to purchase insurance rather than to self-insure. Second, it is required to pay the 20 percent of the premium that is, for its own purposes, wasted expense because it is unrelated to the losses themselves.

Affiliated insurers

Self-insurance in its simplest form, namely a set aside reserve, is not the only approach which has been opposed by the IRS. The Service also is attacking the use of affiliated insurance companies to which the business pays insurance premiums, arguing that no true insurance contracts exist because risks are not being shifted and distributed.

Both the simple and more complex issues are discussed in more detail in the attached APPENDIX A.

RECOMMENDED LEGISLATION

To remedy permanently the inequities of current tax treatment of insurance premiums and self-insurance reserves, new legislation is needed.

Concepts to be included

The following concepts should be the foundation on which legislation is constructed:

(1) The Code should be amended to explicitly provide that a deduction is allowed in the current year for reserves for clearly defined self-insured losses.

(2) The deductible loss reserve amounts should be determined each year by reference to payments that will be made in subsequent years (including expenses of adjusting a claim or loss) due to events in the current year and that are actuarially predictable in the aggregate with reasonable accuracy. These should include at least tort claims, fraud and embezzlement from financial institutions, and workers compensation claims.

(3) The taxpayer should be required to fund a trust with the deducted amounts to provide security to potential claimants. Income earned on the loss reserve assets should be fully taxable to the taxpayer.

(4) Terminations of the loss reserve trust should be strictly limited to circumstances in which no further claims are pending or are reasonably possible.

(5) Self-insuring through affiliated insurers should be expressly allowed.

These concepts generally are contained in H.R. 2642 by Representative Frenzel. This bill provides an excellent subject for analysis and refinement. We urge the Subcommittee to begin at once to study the approach presented by this proposal.

Estimating revenue effect

Amid the concerns that have been generated by projected federal deficits, we recognize that one of the first questions that is asked of any proponent of new tax legislation is, "What is the revenue effect?"

This is an area that needs very serious attention with respect to deductible loss reserves. Prior efforts to analyze the revenue impact of deductible loss revenues have been impeded by two factors. First, Congressional and Treasury staff have not had definitive legislative language with specific limitations and requirements to use as the subject of a rigorous revenue estimating process. Second, private sector actuarial specialists have not had access to tax data which could be analyzed in the context of specific concepts. With H.R. 2642 now available and with the recent attention given to insurance industry tax data, we urge the Subcommittee to undertake a thorough examination of the revenue estimating issue.

Analysis that I have seen, based on industry data in the absence of tax data, suggests that the proposal could be a modest revenue gainer or revenue loser, depending upon the magnitude of the impact of a number of related factors. These include the following:

(1) For existing self-insurers, allowing a current tax deduction for reserves equal to predicted future payments that will ultimately be deductible anyway would represent only a timing difference.

(2) The income earned on a self/insurer's loss reserve trust would be taxable to the self-insurer. This income would reduce the "revenue loss" attributable to the first-year deduction. Excessive funds in a trust at year end would also be taxable.

(3) Tax exempt self-insurers would generate no revenue impact because their loss reserves would not be deductible.

(4) If changes in tax law encourage increased use of self/insurance loss reserves (as we believe would be the case), insurance companies would pay lower taxes. However, the increased volume of reserves would produce increased income in equal or larger amounts that could be taxable at higher effective rates than the income that is no longer produced by the insurance companies.

CONCLUSION

Risk managers and actuaries are experienced and competent professionals who are capable of advising businesses of all sizes about the reasonable expectations of losses and expenses that will arise currently and be payable in the future. Such work is widely recognized as the basis for establishing premiums for insurance policies. Applying the same expertise to the computation of necessary reserves for defined classes of self-insured losses is not a radical or questionable basis on which to allow a federal income tax deduction. In fact, such self-insurance has been occurring for many years.

Legislation such as H.R. 2642 can remove an inequity that has plagued business risk managers for years. The result can be a workable and secure system of liquid self/insurance trusts and affiliated insurers that reduce the cost of business insurance and have a minimal revenue impact on the Treasury.

The realities faced by insurance companies and self-insurers are virtually identical. The maintenance of reserves are similar. The objectives are the same. For these reasons, we strongly urge that the tax treatment also be parallel.

APPENDIX A

THE NEED FOR TAX DEDUCTIONS FOR CERTAIN LOSS RESERVES

I. BACKGROUND: THE NATURE OF SELF-INSURANCE

The issue of self-insurance arises as part of the general problem of risk management--the question of how to deal with the uncertainties associated with an enterprise. In simplest terms, a business has two choices when confronted with a risk of future loss (which includes damage to or loss of assets as well as payments to outside parties). If insurance of the risk from an unrelated insurer is available, the business can purchase it. This transaction eliminates uncertainty for the business by transferring risk to the insurer. For a fixed fee (a certainty), the insurer agrees to pay whatever losses or expenses eventuate with respect to a specific class of risks, up to the limits of policy coverage. Alternatively, the taxpayer can forego outside insurance and bear risks itself. Taken in a broad sense, the term "self-insurance" refers to such unshifted risk-bearing. In this wider usage, self-insurance takes in all uninsured risks, including both the deductible amount on a policy and the excess risk above its compensation limits.

Recommended legislation, however, would change the tax treatment of a type of business conduct referred to by a narrower sense of "self-insurance." This sense of the term refers to instances where a single business concern is in a position, with respect to certain amounts and classes of risks, to perform the distinctive function of an insurance company, namely eliminating uncertainty by aggregating individual contingencies into a statistically predictable pool of risks. When losses are predictable, the business faces virtually no uncertainty with respect to them. Therefore, the purchase of commercial insurance would not serve its usual purpose, which is the elimination of uncertainty. The price of commercial insurance, however, includes costs in addition to the expected loss on the policy (which loss is the amount the business will have to pay on its own if it does not buy outside insurance). Such expenses—brokers' fees, outside rating services, administrative and defense costs, etc.—usually represent at least 20 percent of the price of outside insurance. When losses are predictable and an outside policy does not reduce uncertainty, that part of the premium is wasted. It is economically preferable, then, for the business to bear those risks itself and budget the associated payments like any other expenses; in other words, the business should self-insure.

Self-insurance can be managed either internally through accounting methods or externally through an affiliated insurer, *i.e.*, a subsidiary that is an insurance company. Internal self-insurance generally involves the creation of a reserve account, in a fashion analogous to the accounting methods of commercial insurance companies. Self-insurance through an insurance subsidiary, from the point of view of the parent, functions just like commercial insurance. The parent pays a premium to the

affiliate, which issues a policy of insurance. In turn the affiliate establishes reserves against losses, as does any other regulated insurer. When claims arise on the policy, the subsidiary insurer investigates and pays as appropriate. The advantages of affiliated insurers include administrative centralization, access to reinsurance markets and the possibility of developing expertise which might make possible an independent profit-center from the writing of insurance for unrelated firms.

II. FEDERAL TAX TREATMENT OF SELF-INSURANCE

The preceding section pointed out that it is more productive to self-insure certain classes of risks than to insure them commercially. Nevertheless, the federal income tax law irrationally favors commerical insurance over self-insurance, causing many businesses to choose the less economically efficient of these two functionally equivalent modes of risk management.[1] This treatment results both from the interaction of the timing of payments under self-insurance with the current application of tax accounting rules for the timing of deductions, and from the Internal Revenue Service's opposition to the deductibility of payments to affiliated insurers. Disparate treatment of self-insurance and commercial insurance encourages businesses to divert funds from productive purposes into the insurance sales apparatus. The recommended legislation would redress this imbalance, leaving the market to determine the optimal allocation of scarce resources.

When a taxpayer purchases insurance to cover risks incurred in year 1, it immediately pays the insurance company a premium. Depending on the risks covered, the insurer will reimburse the insured either for damages or liabilities incurred as a result of activities in year 1. Only a relatively minor number of these payments from the insurer will be made in the year in which the premium is paid. This is especially so with respect to claims of liability by third parties. Suppose a pedestrian claims that the business's truck negligently ran into him during year 1. Very often, the business will deny it is liable, or that the claimant was injured to the extent he alleges. Legal process may continue for several years until the case reaches judgment or settlement, at which point the insurer will pay if and as appropriate. Indeed, the pedestrian may not even assert his claim until year 2. Thus, business can incur liability without even knowing about it.

The same time pattern will occur when such risks are self-insured. Events leading to payment occur in year 1, but payment occurs in a year later. The self-insured taxpayer, however, can actuarially estimate with high confidence in year 1 what payments will eventuate from that year's activities. If therefore charges those future payments to income in year 1. This charge is the equivalent of payment to a commercial insurer. In subsequent years, when payments are made to claimants, these go to reduce the self-insurance reserve account rather than income in the subsequent year.

This method of accounting for predictable risks which the taxpayer bears itself—i.e., self-insured risks—is, indeed, mandated by Generally Accepted Accounting Principles (GAAP). As a rule, GAAP requires that self-insurable losses be charged to income in the period in which they would be commercially insured. For financial accounting purposes, the Financial Accounting Standards Board issued Standard No. 5 in 1974 ("FASB No. 5") which requires that an estimated loss from a loss contingency—shall be accrued by a charge to income if the following conditions are met:

(a) Information available prior to the issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of loss.

(b) The amount of loss cna be reasonably estimated.

For purposes of FASB No. 5, a liability is deemed "incurred" if the events giving rise to the liability have occurred. The loss is "probable" when the future events that would confirm it are likely to occur. Under this definition, highly predictable future payments arising from events that have occurred—self-insured losses—are to be charged to income in the current period.

According to GAAP, then, self-insurance and commercial insurance are to be treated equivalently; the insurance premium and the present value of future payments with respect to self-insured risks are both charged against income currently.

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[1] When aggregate outcomes are predicuable by the individual business, the purchase of commercial insurance does not significantly reduce uncertainty; hence, it is functionally indistinguishable from risk retention through self-insurance.

This equivalence in accounting treatment is in accord with the underlying economic equivalence of the two; in return for a premium paid currently, a commercial insurer agrees to make the same future payments that a self-insurer pays itself. GAAP treats the functionally identical practices in an identical way. Such treatment is also in accord with the fundamental principle of accounting, which is the correct matching of the income and expenses of a period. Accounting for income tax purposes should result in a similar matching. Payments resulting from activities in year 1 are properly charged against the income produced by activities in year 1, no matter when such payments are made.

Under the Internal Revenue Code (section 461 and regulations thereunder), a taxpayer not required to maintain inventories is generally free to use either the cash or accrual method of reporting income. Under the cash method, items of expenditure are deducted in the taxable year in which actually paid. Under the accrual method, a two-factor test for deductibility applies. Treas. Reg. § 461-1(a)(2). The first factor, the so-called "all events" test, requires that all the events must have occurred which establish the fact of liability to make a payment. The second factor requires that the amount of that liability must be determinable with reasonable accuracy.

Historically, the IRS has disallowed a deduction for self-insured losses when the individual claims are not fixed in the current year and/or when liabilities are contested. *See*, e.g., Rev. Rul. 70-262, 1970-1 C.B. 122; Rev. Rul. 79-338, 1979-2 C.B 212; Rev. Rul. 80-191, 1980-2 C.B. 168; Rev. Rul. 81-93, 1981-1 C.B, 322. The IRS has held that if a liability is being contested, the first factor is not satisfied since the fact of liability has not been established. Further, it has generally been held that a liability can only be determined with reasonable accuracy if particular claims of liability, as opposed to aggregate liability, can be so valued. Federal courts tended to follow a very similar line of reasoning into the mid-1970s. *See*, e.g., *Thriftimart, Inc.* v. *Commissioner*, 59 T.C. 598 (1973).

Since 1975, the Ninth Circuit Court of Appeals has addressed self-insured loss reserves in a more surgical manner and in three cases has upheld the taxpayer's deduction, or a substantial portion of the taxpayer's argument while still finding for the government on more narrowly defined matters. *Crescent Wharf & Warehouse Co.* v. *Commissioner*, 518 F.2d 772 (9th Cir. 1975); *Wien Consolidated Airlines, Inc.* v. *Commissioner*, 528 F.2d 735 (9th Cir. 1976); *Kaiser Steel Corp.* v. *United States*, 717 F.2d 1304 (9th Cir. 1983). However, these decisions have not opened the way for significantly more expansive availability of deductions for self-insurance reserves.

As a result, commercial insurance and self-insurance continue to be treated differently. Since an insurance premium is certain, it is deductible when paid. The equivalent self-insurance expenses—payments on losses caused in the current period but paid in later periods—are not deductible until paid, since they are usually contested and are uncertain as to individual cases until paid. This is so despite the overall predictability of self-insured losses and despite the fact that such treatment distorts income by mis-matching taxable periods. The disparity has a much more important result, however. Since current deductions (as generated by commercial insurance) are more valuable than future deductions (as generated by self-insurance), federal tax law favors the purchase of commercial insurance in cases where such a purchase is economically unjustified. The tax system thus misallocates real resources away from productive uses and into the insurance sales apparatus.

The same disparity of treatment will occur between commercial insurance and external self-insurance through an affiliate if the position of the Internal Revenue Service prevails. The IRS currently contends that premium payments to subsidiaries are not deductible because they are not pursuant to "true" contracts of insurance. Contracts between parent and subsidiary do not constitute insurance, the IRS alleges, because they do not entail the "shifting and distributing of risks" which the IRS claims are definitive of true insurance. Accordingly, premiums are deductible only to the extent that risks are effectively shifted out of the "economic family" of the parent. Rev. Rul. 77-316, 1977-2 Cum. Bull. 52. As a result, if this view prevails, a business that is self-insuring through an affiliate will be in the same position as one self-insuring through a reserve account; neither will have a deductible expense in the current year.

The appropriate treatment of affiliated ("captive") insurance companies is much disputed between taxpayers and the Service. See, e.g., Carnation Company, 71 T.C. 400 (1978), aff'd, 640 F.2d 1010 (9th Cir. 1981) (deduction for premium to unrelated insurer which reinsured with taxpayer's affiliate was deemed a "fronting" arrangement and was disallowed). Such situations can become factually quite complex and can present serious issues even if the Service's "risk-shifting" principle is adopted. For example, many wholly-owned affiliates insure risks other than their parents'

risks; some insurance companies are jointly owned by two or more of their customers. While the application of the IRS position to the full range of cases is not certain, one result is clear. If the IRS prevails, payments to wholly-owned, one-customer affiliates will not be deductible as insurance premiums. Moreover, the offshore situs of many affiliates raises policy questions separate from those of riskshifting.

The following five examples illustrate the application of GAAP and tax accounting to various situations.

A. Taxpayer purchases commercial insurance with deductible—highly unpredictable risks

Consider the case of insurance against damage from natural disaster. For the individual business, such risks are not actuarially predictable. Hence, it could not self-insure in the narrow sense discussed herein and covered by recommended legislation, so it will purchase commercial insurance to cover losses above a certain level. Such retained losses are self-insured in the broad sense since the taxpayer bears them itself. But since no loss is predictable, none can be said to be probable, so there is no charge to income under GAAP (nor under the recommended legislation) for the retained risks.[2] Premiums paid to the outside insurer are an expense under GAAP and are deductible for tax purposes.

B. Taxpayer purchases commercial insurance—losses within certain levels are highly predictable

This is the classic instance of true self-insurance and is the type dealt with in the recommended legislation. Usually, self-insuring businesses purchase commercial insurance for losses above a certain level, to cover unlikely losses which could be financially disruptive. Here, there is a loss level within the risk retention amount that the taxpayer can confidently project with actuarial methods; this is the self-insured loss. According to GAAP, the predictable level of loss should be currently charged against income because it has probably been incurred. The insurance premium is similarly chargeable. Tax accounting, by contrast, allows a deduction of the premium but forbids current accrual of any losses which do not meet the "all events" test, i.e., most self-insured losses. Deduction of those losses must wait until they are determined with certainty, which will frequently not happen until a later taxable year.

C. Taxpayer purchases no commercial insurance—certain level of loss predictable

In this case, the business is self-insuring predictable losses in the narrow sense and self-insuring all other possible losses in the general sense simply by not having placed them with an insurance carrier. Here, GAAP mandates that probable losses (the truly self-insured) be charged to income, while remote losses (unpredictable retained risks) not be so charged. Tax principles forbid a reduction for either class of risk until losses are fixed.

D. Taxpayer purchases insurance from an affiliated insurer

Assume for discussion purposes the simplest case, that of a wholly-owned affiliate selling insurance only to its parent. Such an arrangement is treated by GAAP as the equivalent of internal self-insurance. Predictable (probable) losses are to be charged, while remote possibilities are not. The IRS currently disallows deductions for premiums paid to affiliates, although taxpayers dispute this position.

E. Taxpayer purchases insurance from affiliate—affiliate reinsures part of risk

A contract of reinsurance between an affiliate and an unrelated company changes the affiliate scenario. The portion of the taxpayer's premium that goes for reinsurance is charged under GAAP, as are still-retained (i.e., not reinsured) risks of probable loss. However, only the part of the premium attributable to reinsurance—which shifts risk of loss to an unrelated party—is deductible if the IRS view prevails.

III. ISSUES IN DRAFTING RECOMMENDED SELF-INSURANCE TAX REFORM LEGISLATION

Federal tax law should be reformed to accord commercial insurance and self-insurance the same tax treatment when they are functionally equivalent. Were this accomplished, market forces and business economics, rather than tax law, would dictate the choice between the two. A number of issues must be addressed by such reforms.

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[2] Retained risks include both those below the minimum claim amount and above the limits of coverage of the policy.

Defining eligible risks.—The first element in such a reform is the definition of self-insurable risks, i.e., those risks with respect to which a deduction will be allowed. Self-insurable risks have two characteristics. First, their outcomes must be actuarially predictable in the aggregate. This is necessary because self-insurance and commercial insurance are equivalent when an individual business' losses can be projected. Second, self insurable risks are those that result in payments in later taxable years. It is in the case of such delays that the current tax system favors commercial insurance by giving an immediate deduction for premiums and requiring that self-insured losses not be deducted until finally paid.

Amount of the deduction.—Once the classes of risks with respect to which a deducton is allowable are defined, the next issue to be addressed is the amount of the deduction. When insurance is purchased from a commercial insurer, the premium is set by market forces. Because it will have to part with cash, the insured has every incentive to seek to minimize insurance costs—and hence to minimize the deduction. Since a self-insurance system may lack such incentives, some other means is needed to determine the proper charge to income.

The solution is to approximate the market outcome. Taxpayers can obtain the same actuarial-type estimates of their loss exposure that insurance companies use. Such projections are available from a variety of sources—*e.g.*, internal statistics, outside actuaries, and insurers. Use of an affiliate, of course, contains a built-in reference to the market. Under section 482, related corporations are required to transact business on an arm's-length basis.

Security for claimants.—A third question to be addressed is that of the security to be offered claimants for self-insured losses—notably, the outside parties whose liability claims are self-insured. Here the issue arises because of a difference between insurance companies and self-insuring businesses, the equivalence of which is the basis for reform. Self-insurance is meaningful when the business faces little uncertainty as to the amount of claims. The business also faces uncertainty as to its ability to pay claims in the future, even if those claims turn out to be just as expected. Business may be bad, the firm may be insolvent. Commercial insurance reduces this risk, not through pooling, but through the regulation of insurance companies.[3]

Insurers generally are sharply limited by law in their investments. They are required to hold relatively low-risk assets, and they are frequently obliged to maintain a certain level of liquidity. An insurance company, in theory, is less likely to default on its obligations (and of course also more likely to earn a lower rate of return) than a normal business concern. This second element of risk reduction is not available in self-insurance. The risk of default or delay resulting from cash-flow difficulties is that of the enterprise that self-insures, rather than that of the regulated insurer. The former risk is, as a rule, higher than the latter; machines are more likely to become unprofitable than a diversified portfolio of securities. Policy, then, may indicate that some measures be taken to secure payments on self-insured losses and so further the conformity of self-insurance and commercial insurance.

Affiliated insurers.—Finally, the issue of affiliated insurers arises. The question here is not really central to the recommended reform; valid self-insurance can be accomplished either internally or externally. Rather, as with securing payment, the matter is policy-oriented and not conceptual. Much of the concern with affiliated insurers arises because they are frequently incorporated in jurisdictions other than the United States. As a result, they are not subject to U.S. or state regulations except to the extent required to entitle them to transact business. Moreover, premiums paid to affiliates often involve a flow of funds offshore. While the question of foreign affiliates should be addressed, this issue is not central to self-insurance reform.

Appendix B

A Description of H.R. 2642

The following describes the features of H.R. 2642 by Rep. Frenzel. This discussion is not presented in the order in which technical provisions are set forth in the bill.

Definition of "self-insurable risks"

The first major issue for self-insurance reform is the definition of self-insurable risks. The bill follows the analog with commercial insurance and adapts to the prob-

[3] This regulation by the states is not always successful. Insurance companies from time to time become insolvent or financially embarrassed, frequently as a result of inadequate loss reserves.

lem of tax-accounting. The two central elements of the definition are predictability and delayed payment.

Actuarially predictable

As to the first, the taxpayer must be able to determine with reasonable accuracy at the time of the deduction the aggregate amounts and timing of losses it is self-insuring. This accords with the analogy between commercial insurance and self-insurance as it is the ability actuarially to predict aggregate losses with accuracy that makes it unwise to insure commercially. In such instances, the cost of commercial insurance would be economically wasteful and, but for the disparate tax treatment, more taxpayers would self-insure. The predictability requirement, of course, also protects the revenues by ensuring that deductions will not be based on speculative estimates of liability.

Delayed payments

The second definitional element of self-insurable risks is that they involve delayed payments—payments (and discoveries of losses where no payment is involved) in years subsequent to the year in which events occur which give rise to the loss. It is this characteristic which produces the tax disincentive to self-insurance; commercial insurance premiums are currently deductiable while their functional equivalent, delayed payments, entail delayed deductions. Here the bill is in accord with the FASB No. 5 definition of a contingency—a financial event arising from occurrences in the current year which may eventuate as a loss or payment in a later period.

Specific classes of risks

Moreover, the definition limits self-insurable risks to those that most especially exhibit these characteristics—tort liability payments to third parties and similar claims such as workers' compensation and financial fidelity. The involvement of outside claimants is by far the most common cause for delays in reporting claims and disputes as to the fact and amount of liability. Both of these effects combine with the "all events" test to produce deductions in taxable years subsequent to that in which the event occurred. Workers' compensation is quite similar, although the concept of establishing negligence has been removed by statute. Financial fidelity losses—resulting from the defalcations of employees and others dealing with financial institutions—also exhibit delay as a result of the involvement of persons other than the taxpayer. Moreover, the involvement of third parties adds to the expense of prediction and claims handling, which exacerbates the duplication of effort involvement in commerical insurance. These instances are, then, prime candidates for self-insurance in a variety of ways.

AMOUNT DEDUCTIBLE

The amount deductible is determined in a fashion analogous to the bookkeeping of an insurance company. In the first year, the taxpayer projects the present value of lossess arising form that year's activities. This amount is deducted from income and added to the trust fund or reserve account. At the end of each subsequent year, the present value of all outstanding future payments—called the "current liability"—is recomputed, including the future payments arising from events in that year. This annual recomputation (which is required whether a deduction is taken or not) also makes possible the adjustment of prior years on the basis of new information. Once the current liability is determined, the difference between that quantity and the balance in the trust or account is deducted from income and added to the trust fund or reserve account. If the account or fund balance exceeds the current liability, the difference is taken into income. In this manner, the amount in the reserve at the beginning of each year will be equal to the projected outstanding self-insured liability.

Central to this system is the projection of future losses arising form self-insured risks. Various ways of calculating this amount are available. Taxpayers may have their own information and techniques, they may employ outside actuaries, or they may arrange for an independent insurer to perform the computation. Any reasonable method of determining this amount is permitted.

The proposal provides that reasonable methods include (but are not limited to) two techniques that estimate the market outcome—independent actuarial projection and actual insurance quotation. Use of actuaries, of course, parallels the practice of insurers.

The other system estimates market prices by requiring a quotation of the amount that an independent insurer would require to insure the current liability, taking into account the trust or reserve account. A deduction of 90 percent of this amount

is allowed for each year. The 90 percent limitation performs several functions. First, it eliminates revenue loss from self-insurance as compared to commercial insurance, since the deductions generated by the former will have to be less than those of the latter. It also prevents manipulation of the deduction by taxpayers by subjecting their deductions to market discipline. Finally, it ensures that self-insurance will only be undertaken where it will result in real economic savings by being less expensive than outside coverage.

Setting an amount deductible for premiums paid to affiliated insurance companies involves no such special prescriptions. Parents and subsidiaries are required to contract on an arms-length basis. This requirement is enforced by Code section 482. As a result, the Code already requires that the parent-subsidiary premium will be a market rate minus the real savings that the affiliation relationship makes possible—dispensing with sales commissions, administrative duplications, etc. Any further regulation of the affiliation relationship would interfere with the existing regime governing inter-company transactions.

LOSS RESERVE TRUST

In order to provide security for potential claimants—and thus approximate the operation of insurers—the bill requires creation of a trust fund to be adminstered by a qualified trustee, to protect potential claimants.[1]

Stand-by trust

Two ways of guaranteeing payment are available to the taxpayer who creates a trust. One is the "stand-by" trust, which resembles that provided for by the EPA regulations on closing toxic waste disposal facilities. A stand-by trust would be funded in a nominal amount. Its primary function would be to serve as beneficiary of a surety bond or letter of credit guaranteeing payment of self-insured liabilities. The bond or letter would be in the full amount of self-insured liabilities and be issued by an approved bonding company or financial institution.

Operating trust

Alternatively, the self-insuring taxpayer could establish an "operating" self-insurance trust fund. Operating trusts would receive liquid funds and disburse them to claimants. A taxpayer with an operating trust would contribute the amount of his self-insurance deduction, in cash or marketable securities, to the trust fund. The trustee is empowered to invest the funds. Such investments (up to 50 percent of the trust corpus) may include loans to the grantor taxpayer at prevailing market rates. In turn, the trustee would make payments out of the corpus to such claimants and in such amounts as the taxpayer may direct.

Investment income on the trust corpus would be taxable to the taxpayer.

Trust continuity

The proposal also contains a subsection providing for continuity of the self-insurance system during changes of business ownership and form. Once a self-insurance trust is created, the taxpayer may not terminate it (nor permit the surety bond or letter of credit to lapse in the case of a stand-by-trust) until all self-insured loss claims are settled. When a corporation liquidates, the plan of liquidations must provide for continued operations of the trust. Of course, when an individual proprietor sells his business, or a corporation sells its assets, liability for previously-created losses remains with the vendor; hence, control over the trust properly remains where it was likewise. Similarly, when control of a corporation changes hands through a stock transfer, there is no need to do anythng about the intact corporation's trust. In the case of merger, the draft permits consolidation of trusts. It also provides for the case of cancellation of a surety bond or letter of credit and for termination of trusts when the taxpayer no longer insures and all outstanding self-insurance claims have been settled.

Mr. GIBBONS. Mr. Blomquist.

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[1] This bill make clear that the creation of a self-insurance trust does nothing to shift whatever civil liability is involved. The taxpayer, not the trust, remains solely liable for any claims.

STATEMENT OF CARL A. BLOMQUIST, CHIEF EXECUTIVE OFFICER, MUTUAL PROTECTION TRUST, AND THE COOPERATIVE OF AMERICAN PHYSICIANS, INC.

Mr. BLOMQUIST. Mutual Protection Trust supports the passage of H.R. 4859. MPT is a cooperative with 2,200 California physician surgeon members, and provides medical malpractice coverage to members and litigation and patients.

H.R. 4859 changes existing law to include in the taxable income of medical malpractice cooperatives, such as MPT, payments by physicians and surgeon members to the cooperative's reserve of trust funds.

Members of the cooperative will obtain parallel deductions for those payments as ordinary and necessary expenses of their medical practice, and to provide equity with the tax treatment now given to the reserve of premiums of commercial insurance companies.

H.R. 4859 is patterned after similar tax legislation unanimously adopted by the State Assembly and Senate in California and signed by the Governor, George Deukmejian on September 27, 1983.

I am advised that Mr. Thomas, in his earlier discussion during this hearing with Mr. Pearlman of the Treasury determined that the Treasury had no objection to H.R. 4859, the bill that I am prepared to give further testimony on behalf of.

I am, therefore, prepared to continue on with my statement or to merely go on record with my written testimony as presented.

Mr. GIBBONS. All right, sir, your entire statement and the written statement of Congressman Thomas will be included in the record at this point.

[The prepared statements follow:]

STATEMENT OF HON. WILLIAM M. THOMAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, I want to thank you for this opportunity to testify on self-insurance issues. Both as a cosponsor of the legislation on nuclear decommissioning that is before us today, and as the author of the legislation on mutual protection trusts, I am pleased to see these hearings held.

As others will address the decommissioning issues, I want to devote my time to H.R. 4859, which would facilitate the formation of self-insurance trusts designed to reduce the costs of medical malpractice insurance coverage. Legislation to encourage this kind of trust is needed to help cut this aspect of the cost of medical care.

It is no secret that the cost of medical care is expanding rapidly. In 1982, for example, health care costs increased at a rate three times the national rate of inflation. Current expectations are that these costs will continue to increase through the next decade, as the anticipated 13% increase in Medicare outlays would indicate.

Congress is beginning to examine new techniques for controlling costs increases, a direction I strongly support. New systems of cost control in Medicare, such as the recent adoption of Diagnosis-Related Groups compensation rates, are representative of the kinds of options we are now exploring. We should not, however, assume that the services themselves are the only area where cost control is possible.

Another area where costs have rapidly expanded is that of medical malpractice insurance. Malpractice awards have also grown rapidly during recent years, and the cost of obtaining coverage has kept pace with the awards. While not suggesting that we attempt to limit recoveries in malpractice cases, I do not believe Congress should think about ways to reduce the costs of malpractice insurance, a cost doctors often pass through to the patients they treat.

With this in mind, certain innovations in the use of self-insurance ought to be considered. Physicians in California have in some cases banded together to form mutual protection trusts devoted to providing malpractice insurance. In these

groups, physicians are in effect insuring each other rather than buying insurance from commercial insurers.

The experience with these self-insurance groups has been positive. Because doctors examine trust participants' practices, these associations tend to be self-policing and oriented toward reducing possible occurrence of malpractice. As well, the trusts can provide significant cost savings to the medical profession. Figures I have seen show that mutual protection trusts can provide coverage at about a third of the cost of insurance provided by commercial carriers. Perhaps as important, the increased use of such trusts would encourage commercial insurers to be increasingly competitive in structuring their own rates.

California's legislature recently acknowledged the value of self-insurance trusts by passing Assembly Bill 301, which provides for deductions from state income tax liability for amounts contributed to mutual protection trusts. The bill has been signed by Governor Deukmejian. However, the benefits of this legislation will only be available if similar tax changes are made at the federal level.

H.R. 4859 would allow doctors to deduct their contributions to a self insurance trust fund if they elect to do so. If such an election is made, the contributions would be considerable taxable income to the trust. This surmounts problems in H.R. 4859 that the Department of the Treasury has seen in past versions of the bill and it is my understanding that the Department is not opposing the revised version placed before you.

Such trusts are extremely hard to create today. Doctors can fully deduct their malpractice insurance premiums, but they cannot deduct the contributions they make to mutual protection trusts. Naturally, this format encourages physicians to opt for commercial insurance because it offers a relative tax advantage.

Given the importance of this legislation and its value in reducing the cost of medical malpractice, I hope that the Subcommittee will recommend passage of H.R. 4859, and I thank the Subcommittee for its consideration.

STATEMENT OF CARL A. BLOMQUIST, CHIEF EXECUTIVE OFFICER, MUTUAL PROTECTION TRUST AND COOPERATIVE OF AMERICAN PHYSICIANS, INC.

Carl A. Blomquist is the Chief Executive Officer of the Mutual Protection Trust and the Cooperative of American Physicians, Inc. We will be available to testify before this Committee regarding H.R. 4859. Mr. Blomquist's business address and phone number are 7080 Hollywood Blvd., Suite 405, Los Angeles, California 90028, (213) 467-4700.

He will present the views of the Mutual Protection Trust and will not be speaking on behalf of any other client or organization.

SUMMARY OF STATEMENT REGARDING H.R. 4859

The Mutual Protection Trust (MPT) supports the passage of H.R. 4859. The bill changes existing law to include in the taxable income of medical malpractice cooperatives, such as MPT, payments by physician and surgeon members to the cooperative's reserve trust fund. Members of the cooperative will obtain parallel deductions for those payments as ordinary and necessary expenses of medical practice. This will conform the tax treatment of payments to a cooperative's reserve trust fund to existing law which allows a deduction for the "reserve" portion of premiums for commercially available malpractice insurance. H.R. 4859 is patterned after similar tax legislation adopted by the Senate and Assembly of the State of California and signed by Governor George Deukmejian on September 27, 1983.

H.R. 4859 will have the following positive effects:

(1) Increase Treasury revenues by encouraging doctors to use malpractice cooperatives at a cost less than the amount of deductible malpractice insurance premiums;

(2) Rectify existing law which prohibits deduction of payments to a cooperative's "reserve trust fund" but allows deduction of the "reserve premium" portion of commercially available malpractice insurance;

(3) Reduce the costs of malpractice protection and therey reduce the costs of medical care;

(4) Improve the standards of medical practice through membership in a cooperative malpractice arrangement where doctors have a personal stake in the organization and are directly affected by the costs of claims against fellow members; and

(5) Reduce the costs of malpractice protection so that doctors will remain in practice and will not adopt the socially irresponsible alternative of practicing "bare."

STATEMENT OF THE MUTUAL PROTECTION TRUST REGARDING H.R. 4859

INTRODUCTION TO THE MALPRACTICE COOPERATIVE CONCEPT IN CALIFORNIA

In 1975, the Travelers' Insurance Company announced that malpractice insurance premiums for California doctors would increase by approximately 500%. Hospital closures, doctors' strikes, a statewide health care crisis and a special session of the California legislature followed that announcement. Out of the ensuing "malpractice crisis," the Mutual Protection Trust was born.

MPT is a cooperative interindemnity arrangement with over 2,200 California physician and surgeon members. Members of the trust must also belong to the Cooperative of American Physicians, Inc. MPT provides medical malpractice liability protection to doctors and patients under the regulation of the California Department of Corporations. MPT is not an insurance company but the liability protection provided to members is comparable to that offered by commerical malpractice insurers. The members of its Board of Trustees, Board of Directors and committees are full-time practicing physician or surgeon members of MPT. MPT has reduced the cost of obtaining malpractice protection by active peer review, fair and efficient claims settlement practices and elimination of commissioned salespersons and high-priced "attorney-in-fact" management.

In 1983, California adopted legislation to encourage further growth of cooperatives by allowing new physician and surgeon members to deduct the initial trust fund payments to such cooperatives as ordinary and necessary expenses of medical practice. The deduction cannot, however, exceed the amount which could otherwise be deducted as a payment for conventional malpractice insurance and will only be available if similar federal legislation is passed. The California Senate and Assembly, by unanimous vote, have urged the Congress to quickly enact conforming federal law:

"The [California] Legislature finds and declares that the formation of cooperative interindemnity arrangements has contributed significantly to the reduction of health care costs while assuring the highest quality of medical treatment through effective peer review. This legislation is designed to encourage further utilization of the cooperative form of indemnity to further those goals.

The Legislature encourages the Congress to promptly adopt similar amendments at the federal level so that the benefits heretofore reaped will continue to be enhanced." California Assembly Bill No. 301 (emphasis added).

H.R. 4859 WILL INCREASE TREASURY REVENUE

MPT provides medical malpractice protection to California doctors at a cost significantly lower than insurance carriers. For example, since 1977 the cost of coverage in California for a high risk specialty such as anesthesiology compared to the matured premium rate for comparable malpractice insurance is shown below:

Year	MPT	Commercial claims-made coverage	Commercial occurrence coverage
1977	$23,100	$10,798	$23,904
1978	600	11,968	23,904
1979	600	12,167	21,516
1980	1,100	15,182	20,852
1981	1,075	16,604	19,592
1982	1,075	15,680	18,584
1983	8,337	15,320	20,416
1984	7,900	17,432	15,320
Total	43,795	112,978	166,200

Through 1984, MPT will have saved each member anesthesiologist over $69,000 or $122,000 compared to claims-made or occurrence coverage, respectively. Similar savings have applied to other medical specialties. Encouraging membership growth in MPT will result in additional treasury revenue because the cost of MPT coverage is significantly lower than deductible insurance premiums. The taxable incomes of doctors will increase appreciably if they join MPT.

The California Legislature was convinced that allowing new members to deduct the initial trust contribution would promote further growth of the cooperative con-

cept. The tax deduction is necessary for further growth in order to offset the competitive edge that commercial carriers gain because their own "reserve" premiums are fully deductible. The entry level cost for MPT coverage is higher than the first year's premiums in a commercial insurance carrier.

At the present time the entry level cost for MPT coverage is substantially higher than the first year's premiums in a commercial insurance carrier. In addition, initial premiums for commercial carriers are also often kept artifically low to attract new insureds. Such premiums then become much higher when the "matured" rates in the chart shown above go into effect after four or five years of coverage. Finally, MPT is at a special competitive disadvantage because the commercial carriers emphasize the nondeductibility of the MPT trust contribution in order to make MPT's cost seem inflated.

In the long run, insureds with commercial carriers are likely to pay substantially more for malpractice premiums than the cost of membership in MPT. It is often difficult, however, to convince a prospective member to look several years in the future and compare the total cost of the cooperative concept against the matured cost of insurance. The best way to encourage growth in cooperative malpractice protection is to allow deduction of payments to the cooperative's reserve trust fund.

H.R. 4859 CONFORMS THE TAX TREATMENT OF COOPERATIVE "RESERVE TRUST FUNDS" TO THAT APPLIED TO THE "RESERVE PREMIUM" PORTION OF THE COST OF COMMERCIAL MEDICAL MALPRACTICE INSURANCE

MPT's organization and operation are governed by California Insurance Code Section 1280.7. The law requires that a "reserve trust fund" be accumulated from members before the cooperative can offer professional liability protection:

"The trust agreement shall, as a minimum, contain provision for all of the following matters: (1) An initial trust corpus of not less than ten million dollars ($10,000,000), which corpus shall be a trust fund to secure enforcement of the interindemnity agreement. The average initial contribution to such corpus shall be not less than twenty thousand dollars ($20,000) per member participating in the interindemnity arrangement. No such interindemnity arrangement shall become operative until the requisite minimum reserve trust fund has been established by such participating members."

MPT's trust corpus now exceeds $55 million. The earnings from investment of the trust corpus plus annual dues, ranging from $200 to $1,000 per member depending on medical risk classification, help to pay the administrative expenses of MPT, claims defense costs, claims settlements and adverse judgments. Where it is anticipated that those funds will be insufficient to meet all expenses in the succeeding twelve months, MPT may levy assessments on members to meet the anticipated deficit.

MPT provided coverage from January 1, 1976 through December, 1982 without assessments. The first assessment was levied in January, 1983 and assessments are expected to continue annually. MPT is required by law to disclose to applicants that there can be no guarantee as to the exact timing and amount of assessments and that all members have unlimited personal liability for assessments.

The fundamental difference between the cooperative concept and a commercial insurance carrier is that, other than the reserve trust fund, monies collected from members are used to actually pay losses and other expenses during the year collected. California Insurance Code Section 1280.7 provides that the exemption from regulation by the Insurance Commissioner is only available to organizations which "do not collect in advance of loss any monies other than contributions by each member to a collective reserve trust fund or for necessary expenses of administration." Commercial insurance carriers collect premiums far in advance of losses paid based upon estimates of eventual liability for events occurring during the current policy period.

Most commercial malpractice insurance available in California is sold on a "claims-made" basis. Under a claims-made policy, the insurance company indemnifies the insured only from liability for claims which are actually asserted during the policy period, regardless of whether the occurrence giving rise to the claim took place during that period. A doctor insured under a claims-made policy must continue buying the insurance from year-to-year despite increasing premiums or be left without coverage for incidents occurring during the policy period but not maturing to claims during that period.

It is well understood that a significant portion of the claims-made premium is collected in anticipation of losses to be paid many years in the future. Nevertheless,

under existing law such premiums are fully tax deductible in the year paid. As one commentator explains:

"In rulings stretching back over many years, the Service has repeatedly held that amounts paid to a mutual insurance company or a reciprocal interinsurance exchange on account of premiums for business insurance are deductible by the policyholder even though, because of the high level of risks that may be involved in the particular insurance afforded, a portion—even a substantial portion—of the total premium is treated by the insurance company as a *'redundant premium,' i.e., one which exceeds the estimated current year's losses and expenses,* and permits an addition to insurance company reserves for future years." Martin, Forming a Mutual Malpractice Insurance Company, 29 Tax Lawyer No. 3, 581, 588 (emphasis added).

The "redundant" portion of the premiums collected may be substantially more than the amount collected to pay current losses:

"Where the margin between probable losses and those reasonably possible is very large, redundant premiums may rise as high as 90 percent of the total premium." Martin at page 607.

Similarly, a deduction for "reserve premiums" paid under certain medical malpractice insurance policies was recently upheld by the Internal Revenue Service. In April, 1983 the Service issued its Revenue Ruling 83-66 holding that reserve premiums are deductible by the physician in the year paid as a business expense. The insurance policy examined by the Service required payment of a basic premium and reserve premium. A "retrospective" refund of the reserve premium was available to the taxpayer if the insurance company's loss experience turned out to be less than projected. A question was raised whether the possible refund of the reserve premium would prevent tax deductibility. The Service ruled that the reserve premiums would be fully deductible as ordinary and necessary business expenses in the year paid.

The payments to MPT's reserve trust fund should receive tax treatment consistent with reserve premiums charged by commercial carriers. It is possible that MPT members may receive refunds of the payments to the reserve trust fund upon death, retirement or involuntary termination of membership but, in that event, H.R. 4859 provides that the refund will be recognized as taxable income to the doctor in the year of receipt.

COOPERATIVE INTERINDEMNITY ARRANGEMENTS HOLD DOWN THE COST OF MALPRACTICE PROTECTION AND INCREASE THE STANDARDS OF MEDICAL PRACTICE

Every cooperative member has unlimited personal liability for assessments necessary to meet claims costs. Since every member knows that the amount of annual assessments relate directly to MPT's total claims costs, there is an incentive to monitor the professional practice of fellow members. This process is known as "peer review."

MPT's formal peer review process begins with the Quality Control Board. Members appointed to this board are responsible for screening new applicants for MPT membership. A detailed description of an applicant's qualifications and letters of recommendation are considered and personal interviews are conducted before a decision is made. Only applicants whose professional records and qualifications can be attested to by their peers are accepted for membership.

Existing members' medical practices are reviewed by MPT's Peer Review Committee. Members may be referred to the Peer Review Committee for inordinate frequency or severity of claims or any other reason which indicates a particular problem in the member's practice. The Peer Review Committee has been very successful in changing practice habits of members in order to reduce the likelihood of claims. While termination of membership is possible, the Peer Review Committee emphasizes other alternatives including practice restrictions, disciplinary action, continuing medical education, changes in office procedures or other measures designed to improve the quality of care. Members are counseled by the Committee to make changes in their practices in return for continued MPT membership.

Unlimited personal liability for assessments also creates an informal peer review process. Members receive a roster of all physicians and surgeons in MPT. They are informed of the names and medical specialties of all new applicants being considered for membership. If a member finds that an existing or prospective member's practice habits may be below the standard of care, informal counselling will occur to improve the quality of professional practice. This reduces the claims exposure of all members and improves patient care. In addition, members can provide information about new applicants directly to the Quality Control Board so that practice restric-

tions or modifications, if necessary, can be imposed on applicants as a condition of membership.

The membership's desire to hold down the cost of malpractice claims by improving medical standards has led to other loss prevention techniques. A newsletter is published regularly containing articles designed to improve the quality of care rendered by MPT members. Seminars are conducted for MPT members featuring leading experts in the field of malpractice in which the causes of litigation with patients, and ways to prevent it, are analyzed. MPT is sponsoring a project in conjunction with the University of California School of Medicine, San Francisco, researching the doctor-patient relationship and its correlation to malpractice litigation. The loss prevention activities are beneficial to MPT members and to their patients who receive a higher quality of care. All MPT members have an incentive to be watchful about the medical practices of their peers since MPT assessments will rise or fall with the quality of medicine practiced by its members.

MALPRACTICE COOPERATIVES CAN PROVIDE PROTECTION AT REDUCED COST SO THAT DOCTORS WILL CONTINUE TO PRACTIVE MEDICINE AND WILL NOT ENDANGER THE PUBLIC BY PRACTICING "BARE"

During the malpractice crisis in California, many physicians chose to quit medical practice rather than pay what were viewed as exorbitant insurance rates. Other endangered patients who might have legitimate, compensable injuries by practicing without professional liability coverage. Even now, insurance industry sources estimate that at least 20% of all California doctors practice without malpractice protection.

In earlier years, when the cost of malpractice insurance was quite small, coverage was considered merely a prudent business practice. Today, increasing litigation and large judgments against health care professionals make malpractice a necessity. As California proved in 1975, obtaining affordable, reliable and renewable malpractice insurance can be a severe problem affecting doctors, patients and society as a whole.

Encouraging the growth of malpractice cooperatives is one way in which federal and state governments can help doctors obtain coverage at a reasonable cost. More doctors may remain in practice and their patients will have greater protection in the event of injury due to medical error. California chose to encourage the expansion of malpractice cooperatives by granting a tax deduction for payments by members to cooperative reserve trust funds and Congress can provide similar assistance through the passage of H.R. 4859.

CONCLUSION

The passage of H.R. 4859 will bring equity to the tax treatment of malpractice cooperatives by removing the tax advantage enjoyed by conventional insurance carriers. H.R. 4859 will help MPT provide the highest quality professional liability protection for physicians, surgeons and patients at the lowest long-term cost. These goals can be achieved with the prospect of enhancing federal revenues.

The Mutual Protection Trust respectfully requests this Subcommittee to recommend passage of H.R. 4859 to the Ways and Means Committee. The Congress should then be urged to support the goals of cooperative malpractice coverage by approving H.R. 4859.

I

98TH CONGRESS
2D SESSION

H. R. 4859

To amend the Internal Revenue Code of 1954 to provide an election for parallel income and deduction treatment with respect to initial payments made to certain physicians' and surgeons' mutual protection and indemnity associations.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 9, 1984

Mr. THOMAS of California (for himself, Mr. DUNCAN, Mr. ARCHER, Mr. MARTIN of North Carolina, Mr. CAMPBELL, Mr. ANTHONY, Mr. FORSYTHE, Mr. LAGOMARSINO, Mr. STUMP, Mr. DREIER of California, Mr. BADHAM, Mr. FLIPPO, Mr. CHAPPIE, Mr. HEFTEL of Hawaii, Mr. VANDER JAGT, and Mr. PHILIP M. CRANE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to provide an election for parallel income and deduction treatment with respect to initial payments made to certain physicians' and surgeons' mutual protection and indemnity associations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 821 of the Internal Revenue Code of 1954 (relating to mutual insurance companies) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) CERTAIN PHYSICIANS' AND SURGEONS' MUTUAL PROTECTION AND INDEMNITY ASSOCIATIONS.—

"(1) IN GENERAL.—There shall not be included in the gross income of every physicians' and surgeons' mutual protection and indemnity association to which this subsection applies any payment made to such association by a member of such association as an initial payment upon joining such association which payment—

"(A) does not release such member from obligations to pay current or future dues or assessments; and

"(B) is a condition precedent to receiving benefits of membership:

Provided, That such amounts shall be included in gross income to the extent members of such association elect to deduct such amounts pursuant to paragraph (2).

"(2) DEDUCTION ELECTION FOR MEMBERS OF ASSOCIATIONS.—

"(A) ELECTION TO TREAT PAYMENT AS TRADE OR BUSINESS EXPENSES.—To the extent not otherwise allowable under the Internal Revenue Code of 1954, a member of an association described in paragraph (3) may elect hereunder in the manner provided for by the Secretary, with

notice to and with the consent of such association with respect to such election, to treat payments to such association as ordinary and necessary expenses incurred in connection with a trade or business for purposes of the deduction allowable under Section 162, to the extent such payment does not exceed the amount which would be payable to an independent insurance company for similar insurance coverage (as determined by the Secretary). Any excess amount not allowed as a deduction for the taxable year in which such payment was made pursuant to the limitation contained in the preceding sentence shall, subject to such limitation, be allowable as a deduction in any of the five succeeding taxable years, in order of time, to the extent not previously allowed as a deduction under this sentence.

"(B) RETROACTIVE EFFECT OF THIS PROVISION.—A member of an association described in paragraph (3) who in earlier years made payments to such association for which deductions were not initially allowed may, to the extent and in the manner provided by the Internal Revenue Code of 1954, amend applicable earlier tax returns to reflect the deductions authorized by this section:

Provided, That the association to which such payment was made consents to such treatment and is able to and does so amend its return for the appropriate earlier year to include such amount in its gross income.

"(C) REFUNDS TO PAYMENTS.—Any amounts attributable to any payments to such association described in paragraph (1) which are later refunded for any reason shall be included in the gross income of the recipient in the tax year received, to the extent a deduction for such payment is allowed. Any amount refunded in excess of such payment shall be included in gross income except to the extent otherwise excluded from income by the Internal Revenue Code of 1954.

"(3) ELIGIBLE ASSOCIATIONS.—This subsection shall apply to every physicians' and surgeons' mutual protection and indemnity association that is taxable under this section and which was operative and was providing medical malpractice liability protection under the laws of any State prior to January 1, 1984."

(b) The amendments made by this section shall apply to payments made to and receipts of physicians' and surgeons' mutual protection and indemnity associations, and refunds of payments by such associations, after December 31, 1983, in

taxable years ending after such date. Such amendments shall also apply to the extent permitted by paragraph (2)(B) of section 821(f) of the Internal Revenue Code of 1954, as added by this Act.

Mr. GIBBONS. Mr. Duncan.

Mr. DUNCAN. I have no questions, Mr. Chairman. I thank the panel for staying with us.

Mr. GIBBONS. I know you all have had to endure a lot of testimony out there today and I have great sympathy for you.

Obviously this is a very complex field and I am sure we will have to pay a lot of attention to it, and we will be. I have been reading your statements as some of you presented them here, and I think I understand what you are driving at.

I hope that we can work out a solution. Thank you very much. This concludes the hearing today.

[Whereupon, at 3 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

AMERICAN MEDICAL ASSOCIATION,
Chicago, Ill., January 6, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The American Medical Association takes this opportunity to express its support for HR 2095 and HR 2486, bills relating to the tax status of physicians' and surgeons' mutual protection associations which are authorized to write medical professional liability insurance.

These bills would amend the Internal Revenue Code to provide tax-exempt status to "physicians' and surgeons' mutual protection and indemnity associations." These are defined in the bills as not-for-profit entities authorized by state law to provide professional liability coverage ("malpractice insurance" in HR 2095), where no part of net earnings inures to the benefit of any private shareholder. The bills would specifically permit the deductibility, as a business expense, of payments made by a physician or surgeon to such an entity.

The pressing need for the legislation stems from the fact that members of these mutual protection trusts are required to make a large, one-time front-end membership deposit which can be as much as $28,000. This contribution is added to the Association's corpus from which claims are paid. This initial payment, however, is not now considered a deductible business expense under the Internal Revenue Code, although subsequent periodic "premium" payments are deductible. HR 2095 and HR 2486 would permit this initial payment to be deductible over five years. When a member withdraws his contribution from the fund, i.e., any portion not expended for claims, the withdrawal would be taxable in the year when the funds are withdrawn.

In making the initial payment to the mutual protection association deductible (over five years), these bills represent an important and a necessary step towards providing equality of tax treatment for this innovative form of essential professional liability coverage. The AMA supports the passage of either HR 2095 or HR 2096.

Sincerely,

JAMES H. SAMMONS, M.D.

AMERICAN PETROLEUM INSTITUTE,
Washington, D.C., February 28, 1984.

Mr. JOHN T. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: In its "Summary of Administration's Revenue Proposals in the Fiscal Year 1985 Budget Proposal," and specifically under the general heading of "accounting reforms," the staff of the Joint Committee on Taxation has discussed on page 30 an issue labeled "premature accruals." The Subcommittee on Oversight of the House Ways and Means Committee, in its announcement of a public hearing, describes this issue as "the timing and measurement of taxpayer deductions for obligations to be paid in the future."

The Joint Committee staff perceives an abuse in that "[p]ermitting a deduction for an expense which is to be paid in the future overstates the expense to the extent the actual expense exceeds the present value. In the case of an expenditure that

will not be paid for many years, allowing a current deduction will in effect result in the Federal Government having the entire burden of the expenditure due to the time-value of money." Summary of Revenue Proposals at page 31.

The Joint Committee staff then describes the Administration's remedy as a "[clarification of] the 'all events' test to provide that no deduction would be allowed until *economic performance occurs*." (emphasis added) Id, p. 31. It is submitted that the staff has overstated the abuse and that the Administration's proposal is not only overkill, but violates a cardinal principle of tax accounting, i.e., the proper matching of income and expense.

CURRENT LAW

The Joint Committee staff accurately reflects present law in its statement that "[U]nder the accrual method, deductions are allowed (1) when all events have occurred which establish the fact of the liability giving rise to the deduction, and (2) the amount can be determined with reasonable accuracy (the 'all events test'.)" Id, p. 30. The following excerpts from *Ohio River Collieries Co.* v. *Commissioner*, 77 TC 1369 (1981), at page 1372, is a good summary of the legislative and judicial background of the "all events" test:

"Section 461(a) states the general rule that a taxpayer is allowed a deduction in 'the taxable year which is the proper taxable year under the method of accounting used in computing taxable income,' and the regulations elaborate on this general provision. For accrual basis taxpayers, such as petitioner, section 1.461-1(a)(2), Income Tax Regs., provides in part as follows:

"Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * * While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

"The 'all of the events' test appearing in the quoted portion of the regulations was first enunciated in *United States* v. *Anderson*, 269 U.S. 422 (1926), wherein the Supreme court stated (pp. 440-441):

"Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and become due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expense appearing on appellee's books. * * *

"It is apparent from the *Anderson* holding and from the principles set forth in the regulations, that petitioner must satisfy two requirements before it properly may deduct the accrued reclamation expense during the tax year ended June 30, 1975:

"(1) All of the events which determine petitioner's reclamation liability must have occurred before the end of the tax year in issue, *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786, 797 (1974); *Thriftimart, Inc.* v. *Commissioner*. 59 T.C. 598, 611-613 (173); *Oberman Manufacturing Co.* v. *Commissioner*, 47 T.C. 471, 477 (1967). This requirement prevents the deduction of an expenditure that might never be made. *World Airways, Inc.* v. *Commissioner, supra* at 802; *Mooney Aircraft, Inc.* v. *United States*, 420 F. 2d 400, 406 (5th Cir. 1969).

"(2) Petitioner must have been able to estimate with reasonable accuracy during the tax year ended June 30, 1975, the amount of the reclamation expenditure to be made in subsequent years. *World Airways, Inc.* v. *Commissioner, supra* at 797, 805; see also *Crescent Wharf & Warehouse Co.* v. *Commissioner*, 59 T.C. 751, 579-760 (1973), revd. on another 518 F.2d 772 (9th Cir. 1975). This requirement provides an element of certainty, although it is not essential that the precise amount of the expenditure be definitely ascertained. *Peoples Bank & Trust Co.* v. *Commissioner*, 50 T.C. 750, 755 (1968); see also *Brown* v. *Helvering*, 291 U.S. 193 (1934); *Harrold* v. *Commissioner*, 192 F.2d 1002, 1006 (4th Cir. 1951). The failure to satisfy either requirement of the foregoing two-step test would be fatal to petitioner's claim. *Southern Pacific Transportation Co.* v. *Commissioner*, 75 T.C. 497, 634 (1980) (Issue (bbb))."

THE PERCEIVED ABUSE

The Joint Committee staff has suggested that there is a tax accounting abuse in the case of a current deduction for an expenditure that will not be paid for many years because the Federal Treasury will bear the entire burden "due to the time-value of money." While such a concept does have a theoretical appeal should a taxpayer estimate (and immediately deduct) the future cost in current dollars, there is no evidence that taxpayers have sustained such treatment. In fact, *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1969) has been cited as authority for the proposition that a deduction for payments to be made far in the future will not pass the all events tests. *See, Income Taxation: Accounting Periods and Methods*, Shepherd/McGraw Hill, page 61-9, wherein it is stated that:

"In *Mooney Aircraft, Inc.* v. *United States*, the Fifth Circuit was faced with a taxpayer that should have had a currently deductible expense, except for the fact that its payment would have been 15, 20, or even 30 years into the future. Under the facts in *Mooney*, the taxpayer issued with each aircraft sold a certificate entitling the bearer to a $1,000 refund when the airplane was retired from service. The court concluded that, although the first part of the all events test had been met, the actual payment was so far into the future that it was simply unrealistic to view it as an expense of doing business in the current year.

"While a taxpayer is generally not required to discount its accrual of expenses to be paid in the future, perhaps the court in *Mooney*, was indirectly doing this. The discounted value, even at the time of the court's decision (1969), of $1,000 paid 15 to 30 years in the future is virtually nil. Under the current interest rates, of course, any discounted value would be even lower."

A further limitation on any abuse is the requirement that a change from the long-standing practice of deducting actual expenses to deducting estimated expenses would generally be considered a change in method of accounting requiring the Commissioner's prior approval. Id. p. 61-9.

Finally, and in particular with reference to natural resources taxation, an examination of the cases favorable to taxpayers, e.g., *Ohio River Collieries, supra*, and *Denise Coal Co.* v. *Commissioner*, 29 T.C. 528 (1957), revd. 271 F. 2d 930 (3d Cir. 1959), and rulings, e.g., Rev. Rul. 80-182, 1980-2 CR 167, indicates that only relatively near term future expenses have been allowed as current deductions.

THE PROPOSED CHANGES

In view of the fact that current law (again with particular reference to natural resources taxation) already authorized the Government to take action against abusive situations, the Administration's proposals go too far and do violence to accrual accounting. The requirement that "economic performance" must occur in the taxable year for a deduction to be allowed is not a "clarification" of the all events test, but rather its elimination.

The only reasonable interpretation of "economic performance" is "cash paid," which means that taxpayers would be on the accrual basis for income and the cash for expenditures. This proposal thus would violate the cardinal tax accounting principle of matching income and expense. Such a proposal also diverges from generally accepted accounting principles. The Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 19, December 1977, states that: "Estimated dismantlement, restoration, and abandonment and estimated residual salvage values shall be taken into account in determining amortization and depreciation rates." Such a radical change in tax accounting principles as the Administration has suggested does not appear to be justified. However, should a change be found necessary, adhering more closely to the principle of matching income and expense by permitting or requiring a taxpayer to deduct ratably over the life of the asset expense such as removal or restoration costs would tend to eliminate the perceived abuse.[1]

SUMMARY

Tax Accounting abuses, if there indeed are any, do not appear to justify a change from the well-establishd all events test. Certainly there is no demonstrated need for

[1] One aspect of the Administration's proposal is helpful in that it would be appropriate to provide an expanded net operating loss carry-back where a taxpayer is unable to deduct (under the all events test) a reclamation type expense until after an income producing period. It should be noted, though, that the taxpayer is suffering a time-value detriment that would not be prevalent if there were a more proper matching of income and expense as suggested above.

the virtual elimination of the accrual method of accounting. Although imperfect, present law provides a far better matching of income and expense than would the Administration's proposal.

Very truly yours,

CHARLES J. DIBONA.

ARTHUR ANDERSEN & CO.,
OFFICE OF FEDERAL TAX SERVICES,
Washington, D.C., February 24, 1984.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.
(Attention: John Salmon).

DEAR MR. RANGEL: These comments have been prepared in response to announcement PR#14, requesting public comments on deductions to accrual basis taxpayers for amounts relating to future obligations. Arthur Andersen & Co. has prepared these comments on behalf of the Bear Creek Uranium Company. These comments are limited to the impact of Treasury proposals on surface mine reclamation expenses. Arthur Andersen & Co. is submitting a separate statement which addresses in a more general manner the question of deductions for future obligations to accrual basis taxpayers.

Arthur Andersen & Co. has had significant financial tax and accounting experience in the mining industry. Our clients include many of the Nation's major mining companies. In 1982 and 1983 we testified on the tax and accounting treatment of mine reclamation expenses before the Senate Finance Committee's Subcommittee on Energy and Agricultural Taxation. At that time we supported enactment of a rule of law which would permit taxpayers to deduct the costs of mine reclamation on an "as disturbed" basis, i.e., deduct the costs in the year in which the land is disturbed and to the extent of such disturbance. We believe that this rule would be a codification of the current case law and consistent with Treasury's own regulations concerning accrual basis taxpayers and generally accepted accounting principles.

RECLAMATION LAWS

Under both Federal and State laws, surface mine operators are required to reclaim the land that has been disturbed by the mining process. A mine operator cannot begin mining until his comprehensive reclamation plan has been approved. Generally, the operator must post a performance bond to guarantee that the approved reclamation plan will be carried out. Noncompliance can result in civil and/or criminal penalties. Under these rules the operator has fixed and certain legal liability to pay the costs of reclaiming the land and that obligation arises as soon as the land is disturbed.

IMPACT ON THE MINING INDUSTRY

Today, the mining industry, which is critical to our nation's economic well-being, is in a depressed state. The uncertainties involved in mining operations, together with its capital requirements make this industry a high risk business.

There is a long-running controversy between the Internal Revenue Service and the surface mining industry regarding the tax treatment of mine reclamation costs. This controversy has created an atmosphere of uncertainty as to the proper tax treatment of reclamation costs which has had a negative impact on our nation realizing the full potential of our natural resources.

In analyzing the financial aspects of a mine project, the tax treatment of reclamation costs can be a significant factor in determining whether or not a project is economically sound. Rather than risk litigation with the Internal Revenue Service, taxpayers, in evaluating the cash flow and other financial aspects of a particular mining venture, would likely apply the Internal Revenue Service's method of handling such costs with the result that many projects are found to be uneconomical and, thus, are "shelved." We do not believe that such results are consistent with our national goal of minerals and energy independence.

We believe that a rule should be adopted that would permit taxpayers to deduct the reclamation costs when the liability is incurred. This will have a beneficial impact on the industry's cash flow and it will eliminate a significant area of uncer-

tainty in planning mining operations, thus reducing some of the risks inherent in the industry.

ACCOUNTING RULES

For financial accounting purposes, a liability is an obligation that must be satisfied through the disbursement of assets or the performance of services. A liability is recorded as soon as its existence is certain. Even if the exact amount of the liability and the date payable is unknown, once the existence of the liability is certain it should be recorded. Thus, with respect to mine reclamation expenses, generally accepted accounting principles require that the costs that will be incurred to comply with the mine operator's liability to reclaim the land be recorded as soon as the liability exists, i.e., as soon as the land is disturbed.

TAX LAW

This same concept—the fact that a liability exists even though the exact amount and date payable may be uncertain—is provided in the Treasury Regulations relating to the timing of tax deductions for accrual basis taxpayers. Treasury Regulation Sec. 1.461-1(a)(2) provides that an expense is deductible in the tax year in which:

(1) All events have occurred which determine the fact of liability; and

(2) The amount of the liability can be determined with reasonable accuracy.

Thus, under existing income tax regulations, an accrual basis taxpayer may deduct an expense in the year that the fact of liability is established so long as the amount of the liability is then susceptible of reasonable determination.

Pursuant to the requirements of both Federal and state law, a mine operator has fixed requirement to reclaim all land disturbed in the mining process, and that liability arises when the land is disturbed. The first requirement of the regulations, i.e., that the liability be established, is met immediately when the land is disturbed. The seond requirement of the regulations, i.e., that the amount of the liability be determined with reasonable accuracy, is satisfied through engineering studies or through consultation with experts in reclamation work. The cost of the liability should be redetermined annually based upon facts and circumstances in existence at year end.

Despite its own regulations, the Internal Revenue Service has taken the position that reclamation costs are deductible only when the reclamation work is actually performed. This position effectively puts all taxpayers on a cash basis with respect to mine reclamation expenses. The courts have tended to reject the Internal Revenue Service's position and have recognized the validity of deducting accrued reclamation costs when the obligation becomes fixed, i.e., when the earth is disturbed. See *Denise Coal Company* vs. *Commissioner*, 271 F.2d 903 (3rd Cir. 1959), *Commissioner* vs. *Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir. 1954), cert. denied 348 U.S. 828 (1954), and *Pastch* vs. *Commissioner*, 19 T.C. 501 (1952), aff'd 208 F.2d 532 (3rd Cir. 1953). The Tax Court in *Ohio River Collieries Co.* vs. *Commissioner*, 77 T.C. No. 103, reversed an earlier decision, *Harold* vs. *Commissioner*, 16 T.C. 134 (1951), rev'd 192 F.2d 1002 (4th Cir. 1951), and its position is now in accord with the United States Courts of Appeals that have decided the issue.

We believe that enactment of a rule of law which codifies the case law, thus permitting taxpayers to deduct the costs of reclamation in the year in which the land is disturbed and to the extent of such disturbance, would eliminate the uncertainty caused by the failure of the Internal Revenue Service to follow its own regulations and the decisions of the courts.

ADMINISTRATION'S PROPOSAL—PREVIOUS ECONOMIC ARGUMENTS

The Administration's current proposal as it relates to mine reclamation expenditures would add a new criterion to the "all events" test by providing that no deduction would be allowed for reclamation costs until economic performance occurs. Treasury testified on a similar issue before the Senate Finance Committee's Subcommittee on Energy and Agricultural Taxation on May 23, 1982 (copy attached). The testimony contains economic arguments, at least thereof which seem flawed.

(1) Treasury implies that there is a "correct" way to time the reclamation deduction, by emphasizing that taking the deduction in the year the expense is actually incurred ensures that the present value of the deduction is equal to the present value of the expenditure. However, the equality of these two present values by no means ensures "correct" tax policy. In practice, tax policy reflects a number of objectives, and mechanical adherence to one narrow criteria by no means ensures the "correct" outcome.

(2) Treasury argues that the revenue difference, i.e., the present value difference, associated with deducting the reclamation expenses as soon as the taxpayer is obligated to reclaim and that has been disturbed rather than later, when the reclamation work is performed, is substantial. However, the calculations on which Treasury's arguments are based (i.e., 12% afer tax cost of money) use an excesively high interest rate, seriously exaggerating the gap between the two cost recovery methods.

(3) Treasury's statement seems to ignore an indirect revenue effect resulting from the timing of the deduction. Allowing the reclamation expense deduction only in the year the reclamation work is performed will tend to raise product prices and lower output, relative to the situation where the expense can be deducted in the year the producer becomes obligated to reclaim the disturbed land. Lower output levels could offset, to some extent, the increase in revenues Treasury hopes to gain by postponing the deduction for reclamation costs.

1. The "correct" solution

Treasury, in its previous testimony adopted a narrow and self-serving view when it attempted to illustrate that allowing a producer to deduct reclamation costs when the land is disturbed would provide "too much" tax relief and further that the "correct" answer would place the deduction in the final year of the project.

In fact, Treasury is correct only in arguing that allowing the deduction in the year that it is paid will result in a situation where the present value of the deduction is equal to the present value of the funds used to satisfy the legal obligation for reclamation. This logic, however, contains a mortal flaw in that the time for the deducting of an expense and the including of revenue in income, for Federal income tax purposes, has never been determined to be the actual point in time when the present value of the deduction or item of income equals the funds paid or received.

It is interesting to note that at the time Treasury promulgated their regulations defining when an expense becomes an allowable deduction for Federal income tax purposes, the Court of Appeals had already recognized the validity of deducting reclamation costs prior to the time when the work was performed. If Treasury were in serious disagreement with the Court's conclusion, they could have overidden this conclusion or dealt with the present value approach in their regulations, but chose not to do so. Treasury in their prior testimony has stated ". . . our present income tax system does not reach this result because it does not take into consideration the time value of money." Thus, when Treasury argues that allowing a deduction for reclamation costs when the legal obligation to reclaim arises would leave the present value of the deduction greater than the present value of the expense, they are correct only from a purely mathematical point of view; however, such axiom has no relevance to the Internal Revenue Code as it exists today.

Accrual basis accounting is premised on the fact that income is not necessarily reportable nor expenses necessarily deductible when the funds related to the income or expense are received or paid. Treasury Regulation Section 1.446–1(c), which prescribes permissible methods of accounting for Federal income tax purposes, specifically subsection (1)(ii), states that "Generally, under an accrual method, income is to be included for the taxable year when all events have occurred which will fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy." The regulations go on to require that the method used by the taxpayer be in accord with generally accepted accounting principles applied on a consistent basis. The Financial Accounting Standards Board, in its Statement of Financial Accounting Concepts No. 3., issued in December of 1980, on page 39, paragraph 79 states that "Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for the enterprise in the periods in which those transactions, events and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise." Thus, there can be no question that the present value equation espoused by the Treasury, to support its views in opposition to the proposed legislation, is not relevant to the issues.

Treasury, in their previous testimony on this issue cites Section 462, which was later repealed, as an example of a Congressional attempt to allow the accrual of estimated liabilities for future expenses attributable to income generated in the current year. Section 462 would have permitted the deduction of contingent liabilities and so was repealed shortly after it was enacted. However, the position which we are espousing, i.e., deducting mine reclamation costs on an "as disturbed" basis, concerns itself only with fixed liabilities. Further, Treasury fails to point out that the

tax law today provides many examples of situations where under the accrual method of accounting deductions are allowed where the time lag between the deduction of the liability for tax purposes and the actual payment of the expense can be significant. Two examples will serve to emphasize the point.

Treasury has accepted this concept in the situation where a corporation issues a bond for a cash amount which is less than the face amount of the bond at maturity (i.e., discount bond). By Treasury's own regulations, which recently have been codified, such corporate issuer is entitled to claim, each year, a portion of the difference between the cash received and the face amount of the bond as a deduction for Federal income tax purposes. Here is a situation, specifically sanctioned by the Treasury, that allows a taxpayer a deduction for an expense that will not be actually funded by the taxpayer until the bonds are retired or mature, usually a substantial time period. In this case the present value of the deduction will be greater than the present value of the funds expended to satisfy the expense.

On the other side of the coin take an acquisition of a fixed asset, the cost of which is deductible for tax purposes only over a number of years. In this situation, the taxpayer pays current dollars for the piece of equipment but is entitled to a deduction related to his expenditure only over several years. The present value of the funds expended in this example is clearly greater than the present value of the depreciation deductions. Would Treasury support the correction of this present value imbalance using the same argument they conjure up to argue against taxpayers deducting the costs of reclamation on an "as disturbed" basis? Furthermore, if Treasury were to limit deductions on a present value basis, would they also extend this concept to limit income recognition e.g., accounts receivable?

Moreover, at a time when Congress has mandated a simplification of the tax laws, the introduction of present value concepts to adjust the monetary value of income and deductions would add a complexity to the tax laws the likes of which has never been seen before e.g., the determination of the appropriate discount rate. Although large companies with sizable accounting and tax staffs or the financial resources to hire firms such as mine might be able to cope with this complexity, companies without these resources could not.

2. Treasury's example calculations are misleading

Treasury's previous testimony runs through a series of calculations that purportedly illustrate the impact of claiming the reclamation expense deduction in the year the legal obligation to reclaim arises, rather that in the year the reclamation work is actually performed. However, Treasury's calculations seriously exaggerate the difference in tax revenues between the two deduction methods.

Before examining Treasury's calculations directly, it is useful to consider why the difference in the timing of the deduction matters from the Treasury's viewpoint. If, for purposes of illustration, inflation and cost of money are ignored, then the dollar value of the deduction, and resulting loss in tax revenue to Treasury, would be identical under the two scenarios.

However, it is important to realize that the timing difference may be quite significant to Treasury even though the cash flows may be the same. Treasury will correctly view revenues received in later years as less valuable than revenues received in earlier years. This is true because revenues received in earlier years can be used to reduce Treasury's borrowing costs required to fund deficits in the years between the obligation of the reclamation expenditure and the performance of the work.

Treasury indicates in their testimony that they would quantify the difference in the value of payments received in different time periods by determining the present value of both payments. The payments are compared by determining how many dollars Treasury would trade today for the right to cash flow at a future date. The present value of a future payment is the dollar amount of such payment less the savings in borrowing costs Treasury enjoys by receiving the payment earlier in time.

Two elements are critical in determining the present value of future revenue. First, one must know when, in the future, the revenue will be received. The later the payment, the smaller its present value. This is because the savings in borrowing costs that accrue during the time between the present time and the time of receipt grow daily.

The second key element of the present value formula is the cost of borrowing funds. The higher the borrowing cost, the smaller the present value of a future payment. This is because borrowing costs between the present time and the future payment date will increase as the borrowing rate rises. Consequently, Treasury could accept a smaller payment today in exchange for the future receipt.

The importance of timing

Exhibit II presents the percentage gain to Treasury from allowing a deduction for reclamation costs later in time (i.e., in the year of performance versus the year of obligation) under a variety of interest rate/time span assumptions. These percentage differences are all positive, indicating that deferral of a deduction will always benefit the Treasury. Treasury's analysis implicitly assumes no inflation coupled with a *constant 12 percent after tax* cost of money. The use of a 12 percent after tax rate, as contrasted with a lower rate, overstates Treasury's benefit.

The obvious question is which percentage change is most representative of what will actually occur. Treasury's borrowing rate in excess of the inflation rate is unlikely to be more than 4 percent for the rest of the 80's. For example, Data Resources Incorporated, the largest economic forecasting consultant, in 1983 projected only a 3.2 percentage point difference between the consumer price index and the rate on short-term Treasury bills in 1985. Combining a 4 percent borrowing rate with a six-year time span between the obligation and performance dates (i.e., the time differential used by Treasury in their previous testimony) suggests that Treasury will view deferral of the deduction as enhancing revenues from this item by 21%. This percentage enhancement is considerably less than Treasury implies.

TREASURY'S EXAGGERATION OF THE VALUE OF DEFERRAL

Treasury's testimony includes a series of specific calculations that purportedly illustrate the impact of reclamation deductions on production costs. An examination of these calculations suggests that Treasury assumed an excessively high cost of borrowing for the producer, which resulted in a gross exaggeration of the difference arising from the timing of the deduction. It is probably appropriate to use a before-tax producer cost of borrowing in excess of inflation of 6–8 percent. Previously, we indicated Treasury could expect to borrow at a rate no more than 4 percent greater than inflation. That rate is understandably lower than the 6–8 percent suggested for the producer because loaning money or providing equity capital to producers must be viewed as riskier than loaning money to the Federal Government, thus the producer must pay an appropriate risk premium. In their analysis, however, Treasury implicitly assumes no inflation, and a constant 12 percent after tax cost of money.

If Treasury believes that producers borrow at 20 percent before tax interest rate, then they implicitly are assuming at least a 15 percent cost of borrowing for themselves. At this level, the difference between deducting the reclamation costs in the seventh instead of the first year results in a 56.8 percent increase in the value of the revenues received by Treasury. Comparing this gain to the 21.0 percent gain above suggests that Treasury's assessment of the gain is 270 percent of what it should be.

3. The indirect effect of delaying the deduction

Delaying the deduction for reclamation costs until the work is performed would indeed result in increased revenues for the Treasury in the short run. Furthermore, the previous testimony of Treasury indicates that the producer may be able to absorb some or most of the higher taxes.

In fact, as in most industries, cost increases including tax increases, result in higher product prices and reduced demand. Therefore, a contraction of output will occur which causes a decrease in the tax revenues of the Treasury. This indirect reduction in revenues further narrows the distinction between the alternative deduction methods; however, Treasury completely ignores it.

CONCLUSION

We strongly urge Congress to codify the rule of the regulations and the current case law. The position taken by the Treasury proposal, that a taxpayer may not deduct its accrued reclamation obligation until the performance reclamation work has actually begun, is not consistent with the fundamental accounting principle that a liability should be recorded when known, i.e., when the land is disturbed and when it can be fixed in an amount with reasonable accuracy. The need for development of our natural resources and for restoration of our lands disturbed by surface mining makes it imperative that we do not put artificial hurdles in the way of these national priorities.

The concern for a potential loss of revenue to the Treasury must pale by comparison to the added economic and financial burdens that would be placed on the mining industry if taxpayers are not permitted to deduct accrued reclamation obligations until the actual reclamation work is performed. A rule that would permit mine reclamation expenses to be deducted currently on an "as disturbed" basis has

very narrow implications since it is limited solely to the special factors in the mining industry where, by law, the liability for reclamation costs is clearly established from the moment the land is disturbed.

In conclusion, we believe that the Court of Appeals in *Denise Coal Company*, supra, sets forth our views quite succinctly. "We think it is good business and good accounting and, therefore, ought to be good tax law to allow a reasonable estimate to be setup as a reserve for the fulfillment of this statutory obligation."

Sincerely yours,

BYRLE M. ABBIN.

EXHIBIT I

[For Release Upon Delivery, Expected at 10:00 a.m. EST, December 7, 1982]

STATEMENT OF THE HONORABLE JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY, BEFORE THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to present the views of the Treasury Department on S. 1911 and S. 2642, which would permit both cash and accrual method taxpayers to deduct the estimated cost of surface mining reclamation work in a taxable year prior to the year such work is performed. For reasons that I will discuss, Treasury is strongly opposed to both of these bills.

BACKGROUND

The Surface Mining Control and Reclamation Act of 1977 and similar state laws require surface mine operators to restore land that is damaged by the mining process. In many cases the mine operator either must post a bond to insure his future performance of the required reclamation work or otherwise must demonstrate financial capability to perform the required reclamation work after mining activities are completed.

S. 1911 and S. 2642 are an outgrowth of a controversy which has existed for some time between mine operators and the Internal Revenue Service over the proper time to accrue deductions for the cost of statutorily mandated reclamation work to be performed in the future. The Service takes the position that such expenses are not accruable until the taxpayer incurs a present liability to pay for the reclamation work. Taxpayers argue that the estimated amount of the reclamation expenses should be deductible when the statutory obligation to perform the reclamation work arises.

In a recent decision, the Tax Court held that the estimated expenses of an accrual method taxpayer to be incurred in future taxable years to satisfy its statutory obligation to reclaim strip-mined land were accruable during the year of the mining operation, even though reclamation work had not been started and the taxpayer had no present liability to pay for the performance of such work. *Ohio River Collieries Co.* v. *Commissioner*, 77 T.C. 1369 (1981). S. 1911 and S. 2642 would codify the Tax Court's decision on this issue for accrual method taxpayers and would provide similar treatment for cash method taxpayers.

Description of S. 1911 and S. 2642

S. 1911 and S. 2642 would permit both cash method and accrual method taxpayers, in computing taxable income for any year, to elect to deduct a reasonable addition to any reserve established for the estimated expenses of surface mining land reclamation. The election would be made on a property-by-property basis. For this purpose the term "property" has the same meaning as in section 614 of the Code; that is, each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land is treated as a separate property. The estimated expenses would be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted over the life of the mine as minerals are produced.

The primary difference between the two bills is that S. 2642 also would allow a taxpayer to elect to allocate estimated expenses to the property "disturbed" rather than to minerals extracted. This would mean that expenses could be deducted as the land is "disturbed." S. 2642 does not clarify what types of "disturbance" would give rise to the deduction.

The bills define the "estimated expenses of surface mining land reclamation" as those expenses otherwise deductible under the income tax law which are (1) attrib-

utable to "qualified reclamation activities" to be conducted in future years, (2) are subject to estimation with reasonable accuracy, and (3) are either allocable to minerals extracted before the end of the taxable year (or, in the case of S. 2642, are allocable to that portion of the property disturbed in the taxable year). The term "qualified reclamation activities" is defined as land reclamation activities conducted under a reclamation plan submitted as part of a surface mining permit application under the Surface Mining Control and Reclamation Act of 1977 or under a plan submitted pursuant to a Federal or State law imposing substantially similar surface mining land reclamation requirements. If the amount in any reserve for estimated expenses of surface mining land reclamation is determined to be excessive at the close of any taxable year, then the excess shall be included in gross income in that year. Nonqualified land reclamation expenses of electing taxpayers would be deductible in accordance with regulations to be prescribed by the Secretary.

S. 1911 and S. 2642 also provide special treatment for estimated expenses of surface mining land reclamation that are attributable to mining activities occurring before the first taxable year for which the reserve accounting method is elected and that have not previously been deducted. These estimated expenses are treated as deferred expenses and may be deducted ratably over a 60-month period beginning with the first month of the first taxable year for which reserve accounting is elected. If mining of a property with respect to which there are deferred expenses will be completed in less than 60 months, then the expenses can be deducted ratably over that shorter period.

The bills generally would be effective for taxable years ending after the date of enactment. However, they also would validate retroactively the deduction of these estimated future expenses for accrual method taxpayers who have accrued such expenses for one or more taxable years ending on or before the date of enactment.

DISCUSSION

S. 1911 and S. 2642 deal with a problem of income measurement that is not unique to the mining industry. Taxpayers often generate income in one year and incur an expense directly associated with generating that income in a subsequent year. Indeed, generally accepted accounting principles frequently require the establishment of reserves for such future expenses, thus reducing net profit as reported on financial statements.

At first glance, there is some appeal to taxpayers' claims that they should be entitled to current deductions for these future expenses. The true profit from any income-producing activity can only be determined by taking all related expenses into account. Nevertheless, there are three broad considerations that militate against permitting current deductions for future expenses. First, a rule that grants a deduction today for tomorrow's expense overstates the true cost of the expense to the extent that the rule fails to take into account the time value of money. Second, such a rule is difficult to administer, since estimates of future expenses are inherently uncertain. Finally, the revenue loss from such a rule, applied evenhandedly to all similarly situated taxpayers, would be prohibitive.

The first of these problems—the overstating of the true cost of the future expense outlay—is best demonstrated by example. Assume the taxpayer generates $100 of income in year 1 from an activity which will generate a corresponding expense of $100 six years later (year 7). If the taxpayer is permitted to accrue the $100 expense, he will report no net income from the activity. But since the taxpayer has the unfettered use of the $100 of income beginning in year 1, at the end of six years he will have substantially more than $100 with which to pay the expense. If he has been able to earn a 12 percent after-tax return on the funds during the six-year period, he will have about $200. The problem lies in the fact that the true cost in year 1 of the future outlay is the present value of the outlay amount, which in this case is about $50. thus, the taxpayer's true profit in year 1 is $50 ($100 income less the $50 present value of the future expense), and the appropriate tax (assuming a 50 percent tax rate) is $25. Unfortunately our present income tax system does not reach this result because it does not take into consideration the time value of money.

Conversely, delaying the taxpayer's deduction to year 7 always produces the correct result. In reality what has happended is that the taxpayer has charged $50 for the product sole and $50 to fund his future obligation seven years hence.[1] This

[1] A detailed discussion of the effect of the timing of the deduction for the future obligation on the amount charged to fund that obligation is set forth in the attached appendix.

latter $50 will bear a $25 tax in year 1 and the remaining $25 will grow to $50 in year 7, which will equal the taxpayer's net after-tax cost ($100 expense less $50 tax savings) of the obligation in year 7.

While deferring the tax deduction to the year in which the expense is incurred thus produces the correct result, the taxpayer in some cases may have insufficient income in the later year against which to offset the deduction. The net operating loss carryback provisons will not remedy the situation if the taxpayer had insufficient income in the taxable years to which the deduction can be carried back. If the taxpayer is forced to carry the loss forward, the value of the deduction will decline in present value terms. If relief is considered necessary, then the appropriate solution would be to amend the net operating loss provisions to provide for a longer carryback period in the case of losses of the type at issue here, as has already been done in the case of product liability losses under current law.

A second inequity with deferring the tax deduction may arise when the taxpayer is required to escrow funds currently to meet the future obligation but the taxpayer is not entitled to receive the benefit of a market rate of interest earned on the escrowed funds. However, if the taxpayer is denied such interest on the escrowed funds, his economic disadvantages is caused by the terms of the escrow arrangement rather than by the Federal tax law.

There is precedent in the tax law for reserve accounting methods of the type provided by S. 1911 and S. 2642. The Internal Revenue Code of 1954, as originally enacted by Congress in 1954, contained a provision, section 462, which permitted the accrual of current deductions for future expenses attributable to income generated in the current year. This provision was repealed, retroactively, in 1955. Even though section 462 was consistent with generally accepted accounting principles, the administrative problems and potential revenue losses caused by the provision were found to be intolerable shortly after enactment of the 1954 Code. It was simply impossible to impose any workable limitations on the categories or amounts of the future expenses for which reserves could be established and current deductions claimed, and the potential revenue losses from allowing all similarly situated taxpayers to create and deduct such reserves were unacceptable.

The foregoing discussions makes it clear why Treasury opposes S. 1911 and S. 2642. The mathematical examples show that the denial of current deductions for future reclamation expenses required by Federal or State statutes penalizes taxpayers only to the extent that the taxpayers are unable to obtain immediate tax benefits from the deductions in the year the expense outlays are made. This hardship, if it exists at all, is minimal compared with the unfair advantage that would be given to mining companies by allowing current deductions for the undiscounted amount of the future outlays.

Moreover, the enactment of either of these bills to give special treatment to mining companies would have broad implications with respect to the deductibility of reserves for similar expenses incurred by other taxpayers. If current deductions are allowed for estimates of future reclamation expenses, it would be difficult to deny taxpayers the right to establish reserves for the estimated amount of workers' compensation costs, products liability and warranty claims, unfunded pension liabilities, costs of dismanteling offshore drilling rigs or decommissioning nuclear power plants, and the like. The past experience with the broad rule of section 462 of the 1954 Code shows that the potential revenue losses from applying this accounting method to similarily situated taxpayers would be prohibitive.

Proponents of S. 1911 and S. 2642 argue that our concerns in this area are rendered moot by the *Ohio River Collieries* case, and that the legislation merely codifies current law as to the appropriate time to accrue reclamation expenses. We disagree. We believe that *Ohio River Collieries* was incorrectly decided and that the "all events" test for accruing deductions under current law does not mandate the results provided by the two bills. Rather, we believe that current law allows a deduction for reclamation expenses only when the taxpayer has a present liability to pay for such expenses. However, if legislation is needed to eliminate the uncertainty resulting from the current conflict between the Internal Revenue Service and taxpayers on this issue, the legislation should confirm the correctness of the Service's position and eliminate the ability of mining companies to understate their incomes in the manner allowed by the *Ohio River Collieries* case. In the interim, we intend to continue litigating cases such as *Ohio River Collieries* in order to assure consistent application of the "all events" test of present law.

Finally, regardless of the argument that can be made as to the proper time for accrual method taxpayers to deduct future expenses, there can be no debate about the appropriate time for cash method taxpayers to deduct these expenses. The law has been consistently clear that a cash method taxpayer can only deduct an expense

when he has actually paid it. We strongly object to the provisions in both S. 1911 and S. 2642 that would permit an exception to this longstanding rule.

CONCLUSION

Treasury strongly opposes S. 1911 and S. 2642. The bills would permit mining companies to understate their incomes significantly by claiming current deductions for the undiscounted amount of future expense outlays. More importantly, enactment of either bill would open the way for additional legislation to permit other taxpayers to establish reserves for the estimated amount of future expenses associated with current income-producing activities. The bills should not be viewed as merely codifying existing case law in a discrete area.

I would be happy to answer your questions.

Appendix

Analysis of Alternative Tax Treatments Of Deferred Expenses

I. Nature of the problem

It is frequently the case that a current exchange of goods and services entails completion of a future action by the seller. When that future action requires the expenditure of resources by the seller, the question arises as to whether those expenditures should be taken into account in determining the seller's current year pre-tax or taxable income. The correct answer to this question is a rule which ensures that the amount charged by the seller reflects no more than the resource cost of completing the transaction. The purpose of this Appendix is to demonstrate that the present law rule which requires that the seller include in his gross income for the current year the entire proceeds of his sale while deferring to the later year the deduction of the associated expense generally produces the correct result. The analysis also identifies the error implicit in an alternative rule that would permit the seller to currently deduct the future cost.

The exposition following includes: first, a description of the determination of the price to be charged absent the influence of income taxation; second, a measure of the seller's income in the year a sale is made which requires a future year expenditure; third, a demonstration that the present law rule does not affect the current year price charged; and finally, an identification of the logical error in formulation of the alternative rule under which the seller's current year taxable income is measured as the sales price less the future cost of completing the transaction. The facts of the example used in the testimony will be used to provide numerical results.

II. Determining the current year price to be charged a buyer of goods or services when the seller becomes obligated to incur a future expense.

If all a coal mining company must do to produce a ton of coal for sale is mine it and otherwise prepare it for delivery to a buyer, the price charged would have to be sufficient to cover all the expenses incurred in its production: wages of coal miners, the cost of materials consumed in mining, and a gross return to mining company capital sufficient to cover depletion of its reserves, and depreciation of its equipment and to provide a return to its creditors and equity owners. Since the price to cover all these costs of production multiplied by the quantity

mined is reported by the mining company as "gross income," the company is allowed to deduct the wages paid and the cost of materials used up, since these elements of gross income are allocable to those productive agents. The coal company is similarly permitted to deduct depletion and depreciation costs to determine pre-tax income. After the mining company deducts the interest paid creditors--their share of the pre-tax income from capital employed in the mine--the residual is the pre-tax income of equity owners. Taxation affects the cost of mining coal only to the extent it affects the cost of wages or materials or the pre-tax rates of return of creditors and equity owners. So long as costs incurred in simple mining are appropriately measured and allowed as deductions to the mining company, the income taxation of coal mining companies, per se, does not affect the price of coal.

Now suppose that, in addition to incurring these current costs of mining coal for sale, the mining company must also restore the land to some specified condition after mining is completed. Clearly, an additional cost to the mining of coal has been imposed. Since this future reclamation expense is effectively independent of the mining cost, it can be isolated in determinating its effect on the price of mined coal. Let us symbolize the cost to be charged coal buyers for this service as P_1, the subscript indicating that it is a price to be charged in year #1, when the coal is mined.

If we symbolize the future outlay to reclaim the mined land as O_n, the subscript indicating the year when the reclamation outlay will be made, then the only other determinant of P_1 is the discount rate by which the current year charge can be related to the future outlay. Let us call this discount rate, which is the opportunity cost of shifting payment obligations over time, r. Then, ignoring taxation,

$$P_1 = O_n (1+r)^{-(n-1)}. \qquad (1)$$

That is, referring to the example in the testimony, where O_n = \$100, n=7 and r= 0.12, P_1 = \$100(1.12)$^{-6}$ = \$50.66. The seller would have to charge the buyer at least \$50.66 in year #1 so that, 6 years later, he would have accumulated \$100 with which to cover the costs of reclamation (in year #7). From the buyer's point of view, he would pay no more than \$50.66 in year #1 for he could take that capital sum and accumulate it over 6 years to \$100 and, himself, requite the reclamation cost of \$100.

III. The seller's income.

Suppose that the cost assumptions of the above example hold. What is the measure of the coal miner's income in year #1 when he receives the \$50.66? Obviously, with respect to the \$50.66 received for the sale of coal, it is zero: He has simultaneously received a market payment of \$50.66 but

incurred an obligation to cover a future expense the present value of which is exactly equal to $50.66. Therefore, for financial statement purposes, the receipt of the $50.66 has no effect on the company's income statement; but it will have a balance sheet effect. On the balance sheet, the $50.66 will be an increase in assets (earning 12 percent, by assumption) offset by the recognition that there is a future $100 obligation, less a "discount" of $49.34, which represents the 6-year cumulation of earnings of the $50.66. With each passing year, the mining company will record interest income and a corresponding decline in the "discount" associated with the year #7 reclamation obligation. If it does not in fact accumulate among its assets the interest earned, when the $100 outlay is made the mining company will suffer a $49.34 decline in net worth.

IV. Introducing income taxation.

In order to simplify exposition, we shall now assume the r in equation (1) represents an after-tax rate of return to capital employed in the enterprise. There are two income tax formulations for the treatment of P_1 that will give the same result as equation (1): The present law rule, and another rule which applies the result in III, above, namely, that there is zero pre-tax income in year #1.

First, we rewrite equation (1) to introduce an income tax levied at rate m. If T_1 = tax due in period #1 and T_n the tax due in period n,

$$P_1 - T_1 = (O_n + T_n)(1+r)^{-(n-1)}. \qquad (2)$$

Symbolically, equation (2) simply says that P_1, less tax due when it is received, must be euqal to the future outlay, plus tax then due, when the outlay is made in year n, all discounted to the present.

Under present law, which taxes P_1 as received and allows a deduction of O_n in year n,

$$T_1 = mP_1 \qquad (3a)$$

$$T_n = -mO_n. \qquad (4a)$$

If equations (3a) and (4a) are substituted in equation (2), the result is:

$$P_1(1-m)=O_n(1-m)(1+r)^{-(n-1)},$$

which, of course, is exactly the same as equation (1) after cancelling the (1-m). Applying the present law rule to the factual assumptions in the testimony example produces a P_1 = $50.66, and if we take m = 0.40, $20.26 will be paid in tax (T_1=$50.66 x 0.40) leaving the miner a capital fund of $30.40

which will accumulate to $60 in year #7, at which time the miner will receive a refund of $40 ($T_7$ = -$100 x 0.40) enabling him to cover the $100 year #7 cost.

Of course, if the taxpayer is allowed a $50.66 deduction in year #1 against his P_1 = $50.66 to signify his lack of economic income in that year and is not allowed to take a deduction when the expense is incurred in year #7, T_7=0, the same result is achieved as under present law, and neither rule causes an alteration in the charge for reclamation. But note that, in order to apply the latter rule, the present value of the future cost must be determined, and this requires estimation of a discount rate. In contrast, the present law rule which taxes P_1 and refunds with respect to O_n operates only with actual transactional data and requires no discounting.

V. The effect of erroneously permitting the current deductibility of future (undiscounted) costs.

Suppose we define P_1' to be the year #1 charge for future costs to be incurred by the seller under a tax rule that will permit the amount of the future outlay, O_n, to be currently deducted. Then,

$$T_1 = m(P_1 - O_n) \qquad (3b)$$
$$T_n = O, \qquad (4b)$$

and substituting these in euqation (2) and simplifying, we obtain

$$P_1 = O_n[(1+r)^{-(n-1)} - m]/(1-m). \qquad (4)$$

In contrast with P_1 as determined under present law rules for P_1 and O_n, this rule makes P_1' a function of the tax rate m. In general, for all tax rates greater than zero $P_1' < P_1$, the difference being a tax subsidy to benefit the cause of the deferred expense; it results from the deduction of an undiscounted amount O_n, in year #1, and the subsidy increases with the taxpayer's marginal rate.

For example, continuing to use the testimony example in which $50.66 is the true charge for reclamation a buyer of coal should pay, allowing current expensing of $100 would result in the following:

Miner's tax rate:	P_1' Buyer's reclamation charge	Subsidy ($50.66-$P_1'$)
0.20	$38.33	$12.33
0.40	17.77	32.89
0.46	8.64	42.02

Of course, if competition does not drive down the reclamation charge to miners' customers, the subsidies will be converted into increased monopoly profits of miners. If for example, a monopolistic corporate miner keeps the charge at $50.66, this will increase its after-tax monopoly profit by $22.69 (=the "refund" on $50.66 of current income, less $100, times 0.46), equivalent to a taxable subsidy to him of $42.02, as shown above.

EXHIBIT II

PERCENTAGE GAIN TO TREASURY GENERATED BY DEDUCTING RECLAMATION COSTS WHEN PERFORMED VERSUS WHEN OBLIGATED

	Excess of Treasury borrowing rate over inflation rate—			
	2 percent	3 percent	4 percent	5 percent
Years between obligation and performance:				
1	2.0	2.9	3.9	4.8
2	3.9	5.7	7.5	9.3
3	5.8	8.5	11.1	13.6
4	7.6	11.2	14.5	17.7
5	9.4	13.7	17.8	21.7
6	11.2	16.3	21.0	25.4
7	12.9	18.7	24.0	28.9
8	14.7	21.1	26.9	32.3
9	16.3	23.4	29.7	35.5

STATEMENT OF WARREN Y. JOBE, ON BEHALF OF THE GEORGIA POWER CO.

My name is Warren Y. Jobe, executive vice president of finance for the Georgia Power Company (GPCO). I wish to thank Chairman Rangel and the members of the Subcommittee on Oversight of the Committee on Ways and Means for their willingness to address the issue of timing and measurement of taxpayer deductions for future obligations. GPCO is an investor-owned electric utility which serves approximately 1.3 million customers in the State of Georgia. It is the largest of four operating subsidiaries of the Southern Company. The following comments are offered on behalf of GPCO in support of the testimony given by the Edison Electric Institute (EEI) during the hearings before the Subcommittee on Oversight on February 24, 1984. We wish to limit our comments to the current tax treatment for costs associated with decommissioning nuclear power plants.

GPCO owns 50.1% of two nuclear units at plant Hatch in Baxley, Georgia that produce over 1,600 megawatts of electric power. Additionally, GPCO and its joint owners are currently constructing two other nuclear units at plant Vogtle in Waynesboro, Georgia with a generating capacity of over 2,300 megawatts which are to be placed in operation prior to 1989. GPCO currently owns 50.7% of both Vogtle units. The Georgia Public Service Commission has approved rates to recover GPCO's portion of the costs to decommission the Hatch units of approximately $64 million. Although estimates are not complete for plant Vogtle, it is expected that decommissioning costs similar to those amounts associated with the Hatch units will be incurred. Therefore, it is essential that GPCO and its customers receive fair and equitable treatment of decommissioning costs not only by regulatory bodies but by taxing authorities as well.

We believe that current tax treatment, which denies current tax deductions for the cost of decommissioning nuclear power plants included in utility customers' rates, is unfair and inequitable. The Internal Revenue Service maintains that costs for decommissioning do not meet the so-called "all-events" test of tax deductibility. This test requires that both the fact of a liability and the amount (within reasonable accuracy) of liability be known before a cost may be deducted for income tax purposes. We believe that the decommissioning costs included in our customers' rates do meet both of these criteria. The fact, or certainty, of decommissioning costs is acknowledged by many regulatory bodies including the Georgia Public Service Commission as attested to by their approval of such costs in utility rates. Also, in GPCO's case, these costs are determined by a nationally recognized independent engineering consulting firm which has testified before and convinced our State regulatory body of the reasonableness and certainty of such costs. A further justification of the certainty of decommissioning lies in the licensing requirements of the Nuclear Regulatory Commission (NRC).

The denial of current deductions can create significant cash flow problems for utilities. In GPCO's case, approximately one half of the $64 million of funds which will be collected from its customers over the service life of the hatch units must be paid out in income taxes. This is true because the amounts collected for decommissioning costs by utilities are considered taxable for income tax purposes, while no

offsetting deduction is allowed for such costs until decommissioning actually takes place. Therefore, we strongly favor legislation which would provide a current tax deduction for additions to reserves established for decommissioning costs associated with nuclear power plants. Such legislation, H.R. 2820, has been introduced by Congressman Sam Gibbons and enjoys the co-sponsorship of 38 members of Congress, including 19 members of the Ways and Means Committee. This legislation has also been endorsed by the National Association of Regulatory Utility Commissioners (NARUC). To ensure fair and equitable treatment to all generations of utility customers, we urge the Subcommittee on Oversight to adopt and support H.R. 2820.

Thank you for the opportunity to comment on this important issue.

MIDDLE SOUTH SERVICES, INC.,
New Orleans, La., February 24, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: This letter represents the written statement on behalf of Middle South Utilities, Inc. for the hearing by the Subcommittee (on Oversight of the Committee on Ways and Means) on the issues regarding deductions to accrual basis taxpayers for amounts relating to a future obligation or liability. In particular, this statement addresses the deductibility of nuclear electric power plant decommissioning costs and endorses passage of H.R. 2820.

Middle South Utilities, Inc. (MSU) is an investor-owned public utility holding company that owns all of the outstanding common stock of four operating companies, Arkansas Power & Light Company, Louisiana Power & Light Company, Mississippi, Power & Light Company, and New Orleans Public Service Inc. MSU is an active member of the Edison Electric Institute (EEI), and as such has been involed in the preparation of the testimony presented at this hearing by EEI. MSU fully agrees with and supports EEI's position as presented in that testimony.

Federal regulations require provisions to be made for costs of decommissioning (either through dismantling, mothballing, or entombing) of a nuclear plant before a nuclear reactor is licensed, although specific funding requirements are left to the states. Many state public utility commissions have responded to the federal requirement by allowing decommissioning costs to be recovered in a utility's rates as a cost of service. These commissions recognize that the need to decommission arises from the operation of a nuclear reactor and, therefore, that decommissioning costs are production costs for which the liability is incurred over the plant life and which should be collected concurrently with the operation of the nuclear plant.

Many commissions recognize the time value concept of money in establishing the amounts of decommissioning costs to be charged to ratepayers by allowing for the earnings on these funds prior to the time that decommissioning expenditures are to be incurred. Thus, amounts collected to cover decommissioning costs increase over the operating life of the plant.

Currently, the Internal Revenue Service has been interpreting the existing tax law to mean that amounts collected from customers for decommissioning costs over the life of the plant are includible in income subject to taxation *without* an offsetting deduction until decommissioning costs are actually incurred.

This treatment creates a burden on the consumer as well as the utility. Utilities are allowed by some regulatory commissions to collect revenues sufficient to cover not only the decommissioning costs, but also the income taxes on those revenues. In other cases where the income tax burden is borne by the utility on a current basis, the consumer will still ultimately have to pay for the company's increased financing costs; but the consumer that ultimately pays these increased costs may not be the same consumer that enjoyed the lower costs (without the tax burden) during the earlier operation of the plant.

H.R. 2820, introduced by Congressman Gibbons of Florida, would provide a current deduction for decommissioning costs to the extent that such costs have been allowed by regulatory agencies and recovered from customers. This would permit the amounts recovered from customers and included in income to be properly matched against the corresponding deduction for the accrued decommissioning costs.

Legislation such as H.R. 2820 would relieve the unfair burden of increased charges to customers, and would allow for equity among electricity consumers during the useful life of the facility. In addition, current deductibility would increase the assurance that funds would be available at decommissioning, and would help avoid potential rate increases at the time of decommissioning to compensate

for those funds which were paid in taxes but not available as a refund in the year of decommissioning.

It is our position that nuclear decommissioning costs should be currently deductible in order to minimize electric rate increases and to better assure that the utility will have the financial ability to perform the decommissioning. It is also our position that this treatment is appropriate and consistent with the proper accrual of deductions and the matching of revenues and expenses.

Very truly yours,

MALCOLM H. MCLETCHIE,
Vice President—System Tax & Accounting.

THE NATIONAL COUNCIL OF SELF-INSURERS,
Chicago, Ill., February 7, 1984.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: I understand that the Subcommittee on Oversight is considering legislation to overrule the decision in *Kaiser Steel* v. *U.S.*,

This is a case which decided it was illegal (and unfair) to treat self-insurers differently than it treats insurance companies on the question of deducting the "loss reserve" established for a casualty loss in the year of the occurrence.

For years, Internal Revenue has permitted insurance companies to deduct such reserves against current income, but even though the casualty loss was identical, did not permit self-insurers to do so. Self-insurers could only deduct when they paid the loss. In my appraisal, this has been the principal impetus for self-insurers' creating captive insurance companies, usually foreign captives, just to get around this stubborn Internal Revenue policy. (Of course, these captives produce their own kind of oddities. Senator Dole has scheduled some hearings looking into the deductibility of premiums paid to captives.)

I suggest that the approach of the Ninth Circuit is the straightforward approach, and that Internal Revenue should adopt that decision, and treat casualty loss reserves the same, whether such loss occurs to an insurance company of to a self-insurer, rather than pay premiums to an insurance company. Internal Revenue recognizes the deductibility of insurance premiums as a business expense; when a self-insurer assumes the risk itself, it should be treated no differently in respect to deductions than when its insurance company assumes the risk.

In fact, we would urge adoption of H.R. 2642, which would assure equality of treatment between insurance companies and self-insurers.

I have no acquaintance with members of the Oversight Subcommittee, and will appreciate your transmitting this letter to the Chairman of that committee.

Yours very truly,

DOUGLAS F. STEVENSON, *Executive Director.*

PHILADELPHIA ELECTRIC CO.,
Philadelphia, Pa., February 23, 1984.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: We are well aware that for an accrual basis taxpayer deductions are allowable when all the events which establish the fact of liability have accrued and the amount of the liability can reasonably be ascertained. This position has been taken many times in determining whether or not a liability acutally exists for future decommissioning costs of nuclear power plants and whether or not that liability can be reasonably determined. As a practical matter the liability to decommission a nuclear reactor is an inherent part of the licensing process and the liability to decommission accrues over the plant life of the asset. Federal regulations require that provisions be made for the cost of decommissioning a nuclear reactor before a license can be issued. Decommissioning is not a matter of choice, it is an envionmental fact of operation that must be done with extradordinary care and will be expensive.

While we cannot comment on all the regulatory bodies that acknowledge the certainty of decommissioning we can tell you factually that the Pennsylania Public Utility Commission (Pa. PUC) has been allowing us to collect decommissioning costs as part of our rate structure since 1979. The Pa. P.U.C. has recognized our need to

accumulate funds for decommissioning but more importantly has recognized decommissioning as a cost of production, the liability on which is accrued concurrently with the operation of the nuclear plant. Thus, upon recognizing the liability to exist the Pa. P.U.C. has cooperated in measuring the amount of the liability.

The revenues that the Pa., P.U.C. allows us to collect for decommissioning are supposed to provide the resources for the future decommission of the facility on which the rates are based. However, because the Internal Revenue Service presently makes no provision for the exemption of decommissioning revenues from taxable income or a corresponding deduction for accrued decommissioning expense, it is obvious that the funding we are trying to accumulate for future decommissioning expense will be 46% lower than our goal. The IRS treatment is not only detrimental to our industry but will also cause the consumer to pay a lot more than they should for their electric service.

The inequity of not being able to deduct decommissioning costs as they accrue bears heavily on the utility consumers. Consumers overpay where a utility is allowed by its regulatory commission to collect decommissioning costs as well as the related tax expense because the costs are not deductable for federal income tax purposes. As a result there is a constant gross up of the expense in order to provide for the tax associated with the revenue collected. In this respect the consumer is paying more than the true cost of service. Conversely, under the present system when decommissioning expenses are actually deductible, in the future, future customers, who have not utilized the facilities, will reap unfair benefits through lower federal income tax expense. At present, there is an inequitable distribution of tax benefits and expense to the consumer. How can we resolve this dichotomy? There is only one answer.

Legislation is needed to correct the unfair tax burden on consumers by allowing for the deduction for decommissioning expenses during the life of the reactor. Allowance of current expense for decommissioning expense over a plant's useful life would not represent a tax loss to the U.S. Treasury but rather a deferral of tax in the same manner as depreciation expense creates a deferral. The argument that a precedent would be created for other industries by allowing decommissioning expense as a current deduction is without merit. Federal statutes require the preservation of public health and safety and decommissioning is a one-time expenditure. Our industry cannot be compared to others; it is unique unto itself. Public utility commissions recognize the requriements of the federal statutes and consider decommissioning as a definite expense for which a reasonable cost estimate can be provide. We are of the firm opinion that the "all events test" of the Internal Revenue Code has been met when a plant is licensed and our position has the full support of the National Association of Regulatory Utility Commissioners. We urge your committee to support enactment of H.R. 2820.

Sincerely,

J. F. PAQUETTE, Jr., *Vice President.*

THE SOUTHERN CO.,
Atlanta, Ga., February 22, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

GENTLEMEN: On behalf of The Southern Company and Subsidiaries, this statement is hereby submitted with respect to the timing and measurement of taxpayer deductions for obligations to be paid in the future. Specifically, our comments relate to the issue of deductibility of nuclear decommissioning costs. The Southern Company is the parent firm of four electric utilities in the Southeast: Alabama Power Company, Georgia Power Company, Gulf Power Company, and Mississippi Power Company (herein collectively referred to as the Southern electric system). The Southern electric system provides electricity to some ten million people in a four-state area of the Southeast.

The fact that nuclear decommissioning costs are not considered currently deductible for federal income tax purposes by the Internal Revenue Service (IRS) continues to place a heavy burden on the consumers of the Southern electric system. H.R. 2820, introduced by Congressman Gibbons of Florida, would remove this unfair burden from our consumers by allowing a deduction over the useful life of nuclear power plants for future decommissioning expenditures to the extent that such future decommissioning expenditures are allowed as a cost of service for rate purposes.

BACKGROUND

Before a nuclear reactor is licensed federal regulations require applicants for such licenses to furnish the Nuclear Regulatory Commission with sufficient information to demonstrate that they can obtain the funds needed to meet both the costs of operating the plant as well as the future expenditures for permanently decommissioning the facility. The Public Service Commissions of Alabama and Georgia have responded to the federal requirement by allowing decommissioning costs to be recovered in rates as a cost of service. These two commissions recognize that the need to decommission arises from operating a nuclear reactor and, therefore, that decommissioning costs are production costs for which the liability is incurred over the plant life and which should be collected concurrently with the operation of the nuclear plant.

While the Alabama and Georgia Public Service Commissions acknowledge the certainty of decommissioning costs by allowing for their recovery in rates for electricity, the IRS refuses to accept the certainty of the same expenses for income tax purposes. Currently, the IRS treats amounts collected from customers for decommissioning costs as income that is subject to the corporate income tax without an offsetting deduction until the decommissioning costs are actually incurred. Consequently, a deduction for decommissioning costs will not be available during the life of a nuclear plant.

Impact on the consumer

For the Southern electric system the total future expenditures for decommissioning nuclear power plants in operation and under construction will total hundreds of millions of dollars (in today's dollars—unadjusted for inflation). The inequity of not allowing a current deduction for decommissioning expenses has substantially increased the cost of electricity. In order to provide the necessary funds to decommission a nuclear plant in the future, the Southern electric system must collect from its customers, over the life of the nuclear plant, the projected decommissioning costs. In addition, because a current deduction is not allowed for the projected decommissioning costs, customers of the Southern electric system must also pay the financing cost of funds used by the system to pay income taxes on the amounts collected for decommissioning.

CONCLUSION

H.R. 2820 reflects sound public policy for consumers, utilities, and the U.S. government. Allowance of current deductions for decommissioning expenses over a plant's useful life would not represent a tax loss to the U.S. Treasury. H.R. 2820 merely would advance the time when the Southern electric system may obtain deductions for decommissioning costs. Such legislation would correct the inequity of the tax laws which in effect substantially increase the cost of electricity by the carrying costs of funds used to pay income taxes that result from the nondeductibility of decommissioning costs.

We appreciate the opportunity to comment on the timing and measurement of taxpayer deductions for obligations to be paid in the future (specifically, nuclear decommissioning costs).

Very truly yours,

DEAN HUDSON, *Vice President.*

SUMMARY OF COMMENTS OF THE SOUTHERN ELECTRIC SYSTEM

H.R. 2820 reflects sound public policy for consumers, utilities, and the U.S. government. Allowance of current deductions for decommissioning expenses over a plant's useful life would not represent a tax loss to the U.S. Treasury. H.R. 2820 merely would advance the time when the Southern electric system may obtain deductions for decommissioning costs. Such legislation would correct the inequity of the tax laws which in effect substantially increase the cost of electricity by the carrying costs of funds used to pay income taxes that result from the nondeductibility of decommissioning costs.